

**THE AUDITING IMPLICATIONS OF THE
GOING CONCERN ASSUMPTION UNDERLYING THE
PREPARATION OF FINANCIAL STATEMENTS**

by

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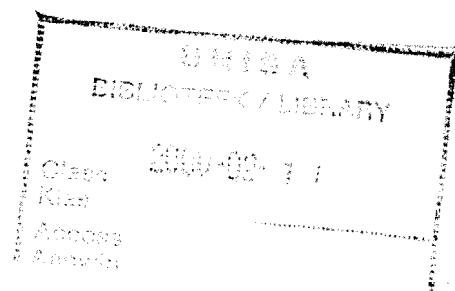
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Blaming the audit report in the case of failing companies is like shooting the messenger who rides in after the event with news which, as we have seen, in many cases is already common knowledge. Does the auditor believe that if he does not question whether the accounts of an insolvent company provide a "true and fair view" it will not fail? Bad management does not need the help of an audit report to bankrupt a business; it is perfectly capable of doing this itself.

Richard Taffler and Meggy Tseung



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ABSTRACT

The overall purpose of this study is to establish

- * whether auditors in South Africa also fail to issue the appropriate audit opinion on the going concern assumption underlying financial statements
- * the reasons for auditors' failure to issue the appropriate audit opinion on the going concern assumption

The hypotheses of this study are tested by

- * examining professional auditing standards and secondary data on the going concern assumption
- * conducting an empirical study of listed industrial companies whose listings were terminated because of financial failure

This study

- * provides evidence that auditors in South Africa fail to issue the appropriate audit opinion on the going concern assumption
- * advances specific reasons for this failure

Keywords

Audit opinion; Audit procedures; Auditing; Auditor's judgment; Business failure; Financial distress; Going concern assumption; Going concern problems; Going concern qualification

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CHAPTER 1

INTRODUCTION AND BACKGROUND

1.1 IMPORTANCE OF THE GOING CONCERN ASSUMPTION

The going concern assumption is a fundamental accounting concept underlying the preparation of financial statements in accordance with generally accepted accounting principles. AC 000, *Framework for the preparation and presentation of financial statements* (SAICA 1990a), contains the following definition of the going concern accounting concept:

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

It is management's responsibility to prepare the financial statements on bases appropriate to the entity. AC 101, *Presentation of financial statements* (SAICA 1999), places an active responsibility on management to assess if the going concern assumption is appropriate for the foreseeable future. It defines the foreseeable future as a period of at least, but not limited to, 12 months from the balance sheet date. The only time when

management can assume the going concern basis of accounting without a detailed analysis, is when the entity has a history of profitable operations and ready access to financial resources. *The code of corporate practices and conduct* (King Committee 1994) requires directors to make a formal statement in the annual report, to the effect that they have no reason to believe that the entity will not be a going concern in the year ahead or to provide an explanation of any reasons to the contrary. However, compliance with *The code of corporate practices and conduct* is voluntary except for companies listed on the Johannesburg Stock Exchange.

The auditor's responsibility, in terms of section 301 of the Companies Act (South Africa 1973) and SAAS 120, *Framework for South African standards on auditing and related services* (SAICA 1996), is to examine the financial statements and to form an opinion as to whether they present the financial position and the results of operations of an entity fairly for a given period. This includes the appropriateness of the accounting bases adopted in the preparation of the financial statements. The auditor thus has a responsibility to evaluate and report whether the entity will be able to continue as a going concern in the foreseeable future.

Mautz and Sharaf (1961:37) included the going concern concept as an auditing postulate, which, according to them, occupies the 'cornerstone position in any edifice of theory'. They explained that it is necessary to include the going concern concept as an auditing postulate because together with other postulates, it provides a basis for a logical integrated theory of auditing. With regard to the going concern concept, Mautz and Sharaf (1961:42) postulated that 'in the absence of clear evidence to the contrary, what has held in the past for the enterprise under examination will hold true in the future'. Without the going concern postulate the auditor has no basis

to accept or verify the assertions made by management in the financial statements with regard to the

- * measurement, recording, valuation and reporting of its assets and liabilities
- * allocation of costs
- * matching of expenses and revenues
- * use of assets and other resources

The more doubt there is about the validity of the going concern assumption, the more doubt there is about the appropriateness of the recorded values in the financial statements. As a consequence, the going concern assumption has a significant effect on the auditor, who is called upon to verify the fairness of the financial statements.

Mautz and Sharaf (1961:49) also believed that the going concern postulate 'places important limits on the extent of an auditor's responsibilities and provides a basis for deducing the extent of his obligation to forecast the future and to have his work judged on the basis of hindsight'. It provides the auditor with a guideline for conducting his or her audit verification work and serves as a protection against changes in the business and economy, which are unforeseeable at the time of conducting the audit. Unfortunately, at the time of the audit of the financial statements, the auditor does not know whether there is a going concern problem of sufficient gravity to undermine the accounting measurements and classifications used in the preparation of the financial statements. To arrive at such a conclusion, the auditor must exercise professional judgment, which is not always a simple task but is based on complex considerations, as will be evident from this study (see chs 4 & 5).

Judgments about the validity of the going concern assumption are linked by the public and financial statement users to judgments about the possibility of business failure. The rate of business failure is an important economic indicator and is the focus of much public attention. In the first quarter of 1999, compulsory liquidations of companies in South Africa increased by 53,6 percent while voluntary liquidations of companies increased by 87,1 percent compared to the same quarter in 1998 (Dommissie 1999:2). The vast majority of bankruptcies involve small firms but the failure rate amongst larger firms is increasing. A South African newspaper (*Business Day* 1991) published the following statistics:

In 1970, only 180 companies went into liquidation. By 1985, this had increased to 3 100. This represents an increase of 1 700% over a 15-year period. Another alarming trend has been the number of JSE listed companies which have recently been either liquidated or “rescued”... There have been more quoted insolvencies in the past two years than in the previous two decades.

While business failure is evidenced by a declaration of bankruptcy followed by liquidation of an entity's assets, many failures involve reorganisation, merger or acquisition of one entity by another and can be classified under ‘rescued’.

Without prior warning about the possibility of financial failure, the decisions of shareholders, creditors and other stakeholders are affected and can incur substantial losses. This is because the asset values recorded in the financial statements are not realised and new or previously undisclosed liabilities come to light. Management may also not be aware of the seriousness of the situation, as when a warning is sounded about the possibility of financial failure.

The focus is therefore on the auditor's responsibility

- * to evaluate the risk whether the going concern assumption underlying the preparation of financial statements is appropriate for the foreseeable future
- * to bring warning signs of possibly financial failure to the attention of management and shareholders early enough, so that potential losses can be reduced or avoided

Conner (1986:77) emphasised this by stating the following:

Public demands for an early warning when a business stands on the brink of failure have never been expressed so forcefully. When businesses fail a short time after an unqualified audit report is issued, what infuriates the public most is that there was not adequate warning of the failure. The public quickly characterizes such business failure as audit failures.

However, auditors have maintained that an unqualified audit opinion issued on the financial statements is not a guarantee that the company has the ability to continue as a going concern and a going concern qualification is not a prediction of business failure (Altman 1982:8; Menon & Schwartz 1986:52).

1.2 PRELIMINARY IDENTIFICATION AND ANALYSIS OF THE PROBLEMS ASSOCIATED WITH THE AUDITOR'S PROFESSIONAL JUDGMENT ABOUT THE VALIDITY OF THE GOING CONCERN ASSUMPTION

The most important problem confronting the auditor in exercising his or her professional judgment about the validity of the going concern assumption underlying the preparation of financial statements, is whether to

- * issue an unqualified audit opinion that the financial statements present, in all material aspects, the entity's financial position, the results of its operations and cash flows fairly
- * express a qualified/adverse audit opinion that there is substantial uncertainty about the going concern assumption

In exercising his or her professional judgment about the validity of the going concern assumption, the auditor can make one of two mistakes:

- (1) Misclassify a nongoing concern as a going concern, which is known as a Type I error
- (2) Misclassify a going concern as a nongoing concern, which is known as a Type II error

There are certain consequences (costs) if a Type I error or a Type II error occurs (see table 1-1). Some of these consequences (costs) can be seen as underlying problems influencing the auditor's decision to issue an unqualified or qualified audit opinion.

TABLE 1-1
CONSEQUENCES (COSTS) IF A NONGOING CONCERN IS MISCLASSIFIED AS
A GOING CONCERN OR VICE VERSA

Consequences (costs) of Type I errors	Consequences (costs) of Type II errors
Negative publicity for the profession and the audit firm	Negative impact on the audit firm's reputation
Integrity and independence of the auditor are challenged	Deteriorating relations with the client
Lawsuits against the auditor by the client's creditors and investors	Potential loss of the client
Scarce economic resources are misallocated	Lawsuit against the auditor by the client
Decisions of entrepreneurs, creditors, investors and others are affected	Cause client to have going concern problems
Management may not be as aware of the seriousness of the situation as when a qualification has been given	

Sources: Altman (1982); Bourne (1986); Kida (1980)

A number of empirical research studies performed in the United Kingdom and the United States of America have examined the occurrence of a Type I error. The results indicated that less than 50 percent of bankrupt companies received a going concern qualification from their auditors for the last financial statements issued prior to the bankruptcy (Altman & McGough 1974; Barnes & Hooi 1987; Citron & Taffler 1992; Peel 1989).

The low accuracy rate of the auditors is even more significant when taking into account that the above-mentioned researchers investigated only those firms declaring bankruptcy, at which stage financial and operating problems are usually at their peak. Business failure, however, develops over time and does not occur without warning (Argenti 1983; Boritz 1991). Long before the actual cessation of operations, an entity will show warning signs of financial distress or impending failure. The auditor should use his or her professional judgment to evaluate the impact of these warning signs on the validity of the going concern assumption.

The auditors of the bankrupt companies in the above-mentioned research studies also failed to comply with the requirements of the professional auditing standards. The standards require the auditor to gather sufficient appropriate evidence to confirm or dispel the doubt about the going concern assumption for the foreseeable future. The foreseeable future represents a period of one year after the balance sheet date (AICPA 1988b) or six months after the date of the audit report; whichever is the later (SAICA 1986).

The results of empirical research studies examining the occurrence of a Type II error indicated that more than 70 percent of companies qualified on a going concern basis actually survived (Altman 1982; Barnes & Hooi 1987; Citron & Taffler 1992). To find the rationale for this is difficult. Peel (1989) hypothesises that these companies either received an incorrect qualification or are correctly qualified on the basis of the information available to the auditor at that time, but subsequently recover and/or are kept afloat for a longer period by factors outside the auditor's scope of vision.

From the above-mentioned statistics it would appear that auditors are not very successful in their professional judgment about the entity's ability to continue as a going concern for the foreseeable future. This has raised considerable scepticism about the auditor's ability to make a professional going concern judgment. It has been argued that the auditor does not have the ability to make a going concern judgment because of his or her limited experience in this area because clients fail only in isolated and infrequent instances (Bourne 1986; Taffler & Tseung 1984). However, the studies of Campisi and Trotman (1985) and Kida (1980) provided empirical evidence that the auditor is sufficiently competent to make a going concern judgment, but that he or she does not issue a going concern qualification because of extraneous factors that influence his or her decision.

The two most common extraneous factors put forward in the literature for the auditor not qualifying when there is uncertainty about the appropriateness of the going concern assumption are the auditor's fear that:

- (1) the qualification will contribute to the client's problems and the downfall of the company; fear of the self-fulfilling prophecy (Citron & Taffler 1992; Kida 1980; Mutchler 1984; Williams 1984)

- (2) the qualification will lead to a deterioration in relations with the client and the eventual loss of a client; fear of auditor switching (Altman 1982; Citron & Taffler 1992; Mutchler 1984; Schwartz & Menon 1985)

The preliminary identification and analysis of the above-mentioned problems associated with the auditor's professional judgment about the validity of the going concern assumption raise questions about the underlying causes of the auditor's failure to issue the appropriate audit opinion. The following hypotheses are formulated in a search for the underlying causes:

- (1) The professional auditing standards do not provide sufficient guidance to the auditor to make a going concern judgment.
- (2) Auditors do not qualify when there is uncertainty about the validity of the going concern assumption because of the possible consequences of the qualification.
- (3) Auditors do not have the ability to make a professional judgment about the continued existence of an entity as a going concern.

1.3 THE PURPOSE OF THE STUDY

The preliminary analysis of the literature in the previous section identified that auditors in the United Kingdom and the United States of America fail to issue the appropriate audit opinion in the audit report on the going concern assumption underlying the preparation of financial statements. The overall purpose of this study is to establish

- (1) whether auditors in South Africa also fail to issue the appropriate audit opinion on the going concern assumption underlying the preparation of financial statements
- (2) the reasons for auditors' failure to issue the appropriate audit opinion on the going concern assumption underlying the preparation of financial statements

1.4 THE OBJECTIVES AND METHODOLOGY OVERVIEW OF THE STUDY

The research objectives, in relation to the overall purpose and the hypotheses formulated in section 1.2, are as follows:

1.4.1 Research objective 1

Determine whether the professional auditing standards provide sufficient guidance to the auditor in the evaluation and reporting of the going concern assumption.

Research method

- (1) Examine the professional auditing standards issued on the going concern by the International Federation of Accountants, United States of America, United Kingdom, Canada and Australia. Compare them with the South African auditing standard with a view to critically analysing the South African standard.

- (2) Examine secondary data from empirical research studies to determine whether the information and guidance supplied by the auditing standards are followed by auditors in public practice to evaluate whether an entity will be able to continue as a going concern in the foreseeable future.

1.4.2 Research objective 2

Determine whether auditors in South Africa qualify the audit reports for uncertainty about the going concern assumption and whether the issuance of Statement on Auditing Standards AU 294, *Going concern* (SAICA 1986) had any effect on the auditors' qualifying behaviour.

Research method

- (1) Conduct an empirical study of industrial companies whose listings were terminated on the Johannesburg Stock Exchange owing to financial failure.
- (2) Select companies failing between 1981 and 1991, thus representing a five-year period before and a five-year period after the issuance of AU 294.
- (3) Examine the audit opinion issued in the audit report for the last available audited financial statements before failure.
- (4) Determine the foreseeable future period for the post-AU 294 group of companies to establish whether the auditors took this period into consideration.

1.4.3 Research objective 3

Determine whether the going concern qualification issued by auditors contributes to their clients' problems and the ultimate downfall of the company, resulting in a self-fulfilling prophecy.

Research method

- (1) Examine secondary data from behavioural research studies to determine auditors' perceptions about a going concern qualification becoming a self-fulfilling prophecy.
- (2) Examine secondary data from research studies reporting on the subsequent status of companies that have received a going concern qualification to determine if the companies did subsequently failed.

1.4.4 Research objective 4

Determine whether the going concern qualification issued by the auditor is associated with the loss of the client, resulting in auditor switching.

Research method

Examine secondary data from empirical research studies to determine whether companies with going concern qualifications switched auditors.

1.4.5 Research objective 5

Determine whether the auditor does have the ability to make a professional going concern judgment.

Research method

- (1) Examine secondary data from empirical research studies that employed statistical models to determine whether the auditor does have the ability to make a going concern judgment.
- (2) Examine secondary data from behavioural studies employing ANOVA and PROTOCOL analysis to determine whether the auditor does have the ability to make a going concern judgment.
- (3) Examine secondary data from empirical research studies that employed expert systems to determine whether the auditor does have the ability to make a going concern judgment.

1.5 OUTLINE OF THE RESEARCH PROGRAMME

The remainder of the dissertation is organised as follows to address the identified research objectives:

- (1) Chapter 2 reviews relevant literature and existing accounting and auditing standards associated with the going concern concept in the context of the accounting field. The purpose of this review is to provide a synopsis of the evolution of the going concern in accounting, a detailed definition and the disclosure requirements in the financial statements of the going concern concept. Chapter 2 also examines the

relationship between the going concern concept, financial distress and business failure.

- (2) Chapter 3 compares various countries' professional auditing standards in order to establish the auditor's responsibility to evaluate whether an entity will be able to continue in the foreseeable future as a going concern and to establish the auditor's reporting responsibility if a going concern problem does exist. The chapter will establish whether the professional auditing standards provide sufficient guidance to the auditor to fulfil his or her responsibilities. The chapter also summarises the evolution of the going concern concept in auditing.
- (3) Chapter 4 reviews and evaluates secondary data from empirical studies that have been conducted on the auditor's professional judgment process in evaluating and reporting whether an entity will be able to continue in the foreseeable future as a going concern. The chapter will establish whether the auditor does issue the appropriate going concern opinion in the audit report, and if not, the reasons for this. The chapter also presents an empirical survey of the professional audit opinion issued by South African auditors in their audit report of companies experiencing going concern problems.
- (4) Chapter 5 will establish whether the auditor does have the ability to make a professional judgment on the continued existence of an entity as a going concern by examining the results of empirical research studies that have employed either statistical models, behavioural analysis or expert systems as a research methodology.
- (5) Chapter 6 summarises the results and conclusions of this research and suggests future extensions thereof.



CHAPTER 2

THE GOING CONCERN ASSUMPTION IN THE CONTEXT OF ACCOUNTING

2.1 INTRODUCTION

Statement of Generally Accepted Accounting Practice AC 000, *Framework for the preparation and presentation of financial statements* (SAICA 1990a) classifies the going concern as a basic assumption underlying the periodic financial statements of an entity. Faul et al (1985:26) classify the going concern concept as an accounting principle, which is defined as generally accepted rules developed on the basis of postulated circumstances and which serve as guidelines for accounting practice. They base the going concern concept on the accounting postulate that the entity will continue to operate indefinitely.¹

The going concern assumption is thus one of the fundamental accounting concepts underlying the preparation of financial statements in accordance with general accepted accounting principles. It establishes the basis for the valuations and allocations used in accounting for example, depreciation and amortisation procedures are based on the principle that the entity will

¹ A corresponding postulate also exists in auditing (see sec 3.1).

continue to operate for the foreseeable future.

Because the going concern assumption is a fundamental accounting concept, it is necessary first to address the accounting implications of the concept before the auditing implications can be discussed. The objective of this chapter is to peruse existing accounting and auditing standards and guidelines in order to:

- * provide a synopsis of the evolution of the going concern assumption in the accounting field
- * define the going concern assumption
- * assess the nature and extent of disclosure requirements in the financial statements when the going concern basis for the preparation of the financial statements becomes questionable or invalid
- * clarify the relationship between the going concern assumption, financial distress and business failure
- * discuss the process leading to financial distress and business failure
- * identify warning signs of the imminent failure of the entity during this process

2.2 EVOLUTION OF THE GOING CONCERN ASSUMPTION IN ACCOUNTING

One of the earliest comprehensive discussions of the going concern assumption appeared in Lawrence R Dicksee's book, *Auditing*, which was first published in London in 1892. His statement on the concept is simple: 'It being the primary object of most ordinary undertakings to continue to carry on operations, it is fair that the assets enumerated in a Balance Sheet

be valued with that end in view' (Storey 1959:233).

The American Accounting Association defined the going concern assumption in 1957 in their *Accounting and reporting standards for corporate financial statements and preceding statements and supplements* as: 'In the absence of evidence to the contrary, the entity is viewed as remaining in operation indefinitely' (Carmichael 1972:90).

Although the going concern is listed as a postulate or concept in practically all accounting literature and accounting textbooks (Grady 1965:27; Moonitz 1961:38-39), critical articles devoted to the going concern assumption are scarce. Sterling (1968:481) wrote:

... the going concern is one of the most important concepts in accounting. Such status would lead one to believe that the concept would be well defined, its necessity as an axiom thoroughly discussed, and its connection to historical cost demonstrated. Anyone with such expectations is due for disappointment.

Sterling perused an Accounting Review cumulative index in 1968 and noted only one article devoted to the going concern assumption. It was written by Reed K Storey. Storey (1959:237) concluded that the going concern concept: '... merely rules out liquidation and requires asset valuation according to intended use'.

Grady (1965:27-28) included the going concern assumption as a basic postulate in his Accounting Research Study No 7 and his explanation of it proceeds from the American Accounting Association's explanation:

... a large part of accounting practice as well as theory is based on the presumption that the accounting entity will continue in operation and not be liquidated in the foreseeable future. In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. ... Indefinitely continuance means that the business will not be liquidated within a span of time necessary to carry out present contractual commitments or to use up assets according to the plans and expectations presently held.

Moonitz (1961) and Grady (1965) list some specific balance sheet accounts for which proper interpretation requires a going concern assumption, namely:

- (1) Accounts receivable. Anticipated future cash receipts are recognised, ignoring the liquidation value of the receivable in the market and any possible legal defect in the transaction.
- (2) Inventories. It is assumed that production will be completed on all unfinished goods, and that they will subsequently be sold at a price high enough to recoup costs. Without this assumption, work in process would be valued very low.
- (3) Buildings and equipment. Changes in immediate market prices are ignored, because the assets will be used, not sold. Thus the entity is presumed to continue at least as long as the useful lives of the assets, permitting the recovery of undepreciated cost from future revenues.
- (4) Intangibles. These costs, often nonmarketable, may be allocated to future periods.
- (5) Liabilities. Estimates for future claims are established and corresponding expenses recorded, even though the legal system might not find an enforceable obligation.

The going concern assumption provides a reasonable basis for presenting the balance sheet accounts of an entity. When the termination of important activities of the entity can be predicted with assurance, the going concern assumption should be partially or completely abandoned. Forced-sale or liquidation values and liquidation commitments are then relevant in the preparation of financial statements (Carmichael 1972:91).

Carmichael (1972:91) describes the going concern assumption's position in the accounting theory as follows:

While accounting literature differs on the appropriate term to describe the going concern idea - postulate, concept, assumption, etc.- there is substantial agreement on the meaning of the term. In accordance with the going concern concept, an entity is presumed to continue in existence indefinitely, although not necessarily in perpetuity; however, contrary evidence may negate this assumption.

But what constitutes *contrary evidence* referred to in the above-mentioned definitions? Carmichael (1972:94) distinguishes between contrary evidence which may imply that the entity has difficulty meeting its obligations (financial problems) and contrary evidence which may imply that the entity fails to operate successfully (operating problems):

Financial problems

Liquidity deficiency. The company's current liabilities exceed its current assets, resulting in difficulty meeting current obligations.

Equity deficiency. The company's solvency is questionable because of a retained earnings deficit or, in more extreme cases, an excess of total liabilities over total assets.

Debt default. The company has been unable to meet debt payment schedules or has violated one or more other covenants of its loan agreements.

Shortage of funds. The company has either limited or no ability to obtain additional funds from various capital sources.

Operating problems

Continued operating losses. No net profit has been earned for more than one past period.

Prospective revenues are doubtful. Revenue is insufficient for day-to-day operating needs, or there have been cut-backs in operations, such as personnel reductions.

Ability to operate is jeopardised. Legal proceedings related to operations may severely curtail operations, or suppliers of operating materials may refuse to transact with the company.

Poor control over operations. The company management have been unable to control operations, as evidenced by repetitive, uncorrected problems.

Sterling (1968:501) did not agree with the explanation of the going concern concept as an assumption. He felt that one couldn't simply assume a going concern because of the uncertainty of what the future holds. In contrast to the going concern being classified as an assumption in the literature, he felt that 'prediction' was a more suitable term, or that the going concern concept must be 'purged' in so far as it applies to the future of the firm. According to him it is also easier to convince oneself of the continuity of an entity on the basis of evidence for continuity rather than on the basis of absence of evidence for liquidation.

This was also Fremgen's (1968:650) viewpoint on the subject. Fremgen stated that the assumption is invalid for '... the thousands of new small businesses which are organised each year and destined to fail within the year'. He felt that the definition should be altered to read as follows: '... the entity is viewed as remaining in operation indefinitely *in recognition of evidence to that effect*'. His conclusion on the subject is that the accountant should not assume that a client is a going concern but should make investigations to ascertain whether or not this is in fact the case.

At this stage, both Sterling (1968) and Fremgen (1968) were advocating the active evaluation of solvency factors before assuming that the entity is a going concern. This is known as the 'active approach' as opposed to the 'passive approach', which was initially absorbed into the accounting literature and professional guidelines (Carmichael 1972:89).

For many years there were no development in the accounting field to change the passive approach towards the going concern concept when preparing financial statements. However, in May 1991 the Cadbury Committee was set up in the United Kingdom by the Financial Reporting Council, the London Stock Exchange and the accounting profession to address the financial aspects of corporate governance.²

The Cadbury Committee was set up for the following reasons (BPP Publishing 1997):

- * because of a lack of confidence in financial reporting
- * because of a lack of confidence in the ability of auditors to provide the assurances required by the users of financial statements
- * because of a lack of confidence in the ability of directors to control their organisations
- * the sudden and unexpected company collapses occurring at that time
- * the resulting lack of accountability by the board of directors in many of these company collapses

² Corporate governance is the system or process by which companies are directed and controlled. Directors of the board are responsible for the governance of their companies whereas the shareholders are responsible for the appointment of the directors and auditors.

Similar developments on corporate governance have taken place in various countries. One of the main reference sources for the Cadbury Committee was the Treadway Report produced by the Committee of Sponsoring Organisations in the United States of America (Williams 1996).

The Cadbury Committee (1992) issued their *Report of the Committee on the financial aspects of corporate governance* that incorporated a *Code of best practice*. From 1 July 1993, all companies listed on the London Stock Exchange, if incorporated in the United Kingdom, were required to make a statement in their annual reports whether or not they had complied with the *Code of best practice* (Williams 1996:9). However, the directors of all companies are encouraged to use the *Code of best practice* for guidance.

The *Code of best practice* (Cadbury Committee 1992) contains the following statement on the directors, responsibility towards the going concern concept: 'The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.'

In the Republic of South Africa, the Institute of Directors appointed the King Committee, which was similar in concept to the Cadbury Committee in the United Kingdom. The King Committee's terms of reference were, however, wider than those of the Cadbury Committee. The King Committee was to make recommendations on the financial aspects of corporate governance, to lay down guidelines for ethical business conduct and to address specific circumstances, such as the disadvantaged communities in South Africa (KPMG 1995:6).

On 29 November 1994, the *King report on corporate governance*, which incorporated a *Code of corporate practices and conduct*, was issued. The *Code of corporate practices and conduct* (King Committee 1994) applies to

- * all companies listed on the main board of the Johannesburg Stock Exchange
- * large public entities as defined in the Public Entities Act
- * banks, financial and insurance entities as defined in the various Financial Services Acts
- * large unlisted public companies (defined as companies with total shareholders' equity in excess of R50 million)

In addition, all other companies are encouraged to adopt the Code.

The *Code of corporate practices and conduct* (King Committee 1994) contains the following statement on the directors' responsibility to report on the going concern concept in their annual report: 'There is no reason to believe the business will not be a going concern in the year ahead or, an explanation of any reasons otherwise.'

The effect of this evolution in the 1990's is that directors are now forced to move from a passive approach, assuming the company is a going concern, to an active one. The active approach means that the directors have to take all reasonable steps to obtain and document the information necessary to support their statement on whether or not they believe that the company will be a going concern in the year ahead.

2.3 DEFINITION OF THE GOING CONCERN ASSUMPTION

A definition of the going concern assumption can be found in the accounting statements of a number of countries. However, not one of the countries has an accounting standard dealing specifically with the going concern concept as such. Guidelines on the going concern assumption were issued by the accounting professions of a number of countries as a result of the reports issued by the various committees on corporate governance (see sec 2.2). The guidelines aim to assist directors in discharging their responsibilities with regard to the appropriateness of the going concern assumption. However, compliance therewith is voluntary and aimed at only certain large entities and companies as previously mentioned, although other companies are encouraged to also comply with the principles (see sec 2.2).

The definition can be found in the accounting statements of the following:

- * International Federation of Accountants (IFAC) - International Accounting Standard (IAS) 1 revised, *Presentation of financial statements* (1997b)
- * American Institute of Certified Public Accountants (AICPA)-Accounting Principles Board (APB) Statement No 4, *Basic concepts and accounting principles underlying financial statements of business enterprises* (1970)
- * Institute of Chartered Accountants in England and Wales (ICAEW) - Statement of Standard Accounting Practice (SSAP) 2, *Disclosure of accounting policies* (1971)
- * Canadian Institute of Chartered Accountants (CICA) - CICA Handbook Section 1000.58, *Financial statement concepts* (1996)

- * Australian Accounting Research Foundation (AARF) - Australian Accounting Standard (AAS) 6, *Accounting policies* (1995)
- * South African Institute of Chartered Accountants (SAICA) - Statement of Generally Accepted Accounting Practice (AC) 101 revised, *Disclosure of accounting policies* (1999)

Key words used in the definitions such as *normal* course of business, *evidence to the contrary*, *foreseeable future*, curtailing *materially* or *significantly* the scale of operations are not elaborated on or clarified in the accounting statements. The auditing guidelines dealing with the going concern concept give a better understanding of these key words but are in some respects still vague as indicated in the summary of the definition.

The auditing guidelines dealing with the going concern are as follows:

- * International Standards on Auditing (ISA) 570, *Going concern* (IFAC 1995)
- * Statement on Auditing Standards (SAS) No 59, *The auditor's consideration of an entity's ability to continue as a going concern* (AICPA 1988b)
- * Statement of Auditing Standards (SAS) 130, *The going concern basis in financial statements* (ICAEW 1994)
- * Handbook Section 5510.51-.53, *Going concern* (CICA 1989)
- * Auditing Standard (AUS) 708, *Going concern*, (AARF 1996)
- * Statement on Auditing Standards (AU) 294, *Going concern*, (SAICA 1986)

2.3.1 Definition of the International Federation of Accountants

The *Framework for the preparation and presentation of financial statements* (IFAC [S.a.]) defines the going concern as follows in paragraph 23:

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

IAS 1 (IFAC 1997b) does not define the going concern assumption but elaborates on management's responsibility for assessing the going concern assumption as follows:

- * Continuity must be assessed by management by considering a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing.
- * The only time that continuity can be assumed without a detailed analysis, is when an entity has a history of profitable operations and ready access to financial resources.
- * Material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern must be disclosed.
- * If the financial statements are prepared on a different basis, not only must the basis used be disclosed, but also the reason why the entity is not considered to be a going concern.
- * Foreseeable future represents a period of at least, but not limited to, twelve months from the balance sheet date.

2.3.2 Definition of the American Institute of Certified Public Accountants

APB Statement No 4 (AICPA 1970) recognises the going concern assumption as a basic feature of financial accounting and defines it in paragraph 117 as follows:

An accounting entity is viewed as continuing in operation in the absence of evidence to the contrary.

SAS No 59 (AICPA 1988b) does not refer to the above-mentioned definition. It states the following:

- * Continuity is assumed in the absence of significant information to the contrary (par 1).
- * The entity will be able to continue to meet its obligations as they become due without substantially disposing of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions (par 1).
- * An entity in the process of liquidation, or where the owners have decided to commence dissolution or liquidation, or where legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable is specifically excluded (footnotes 1 & 2).³
- * A reasonable period of time is regarded as a period not exceeding one year beyond the date of the financial statements (par 2).
- * Examples of contrary evidence are given and categorised into negative trends, other indications of possible financial difficulties, internal matters and external matters that have occurred (par 6).

³ This means that the point in time for an entity no longer to be considered as a going concern is earlier than under the guidelines of IFAC, ICAEW, CICA and SAICA.

2.3.3 Definition of the Institute of Chartered Accountants in England and Wales

SSAP No 2 (ICAEW 1971) identifies four fundamental accounting concepts as the broad basic assumptions underlying the periodic financial statements of business enterprises. The going concern assumption is one of the four concepts and is defined in paragraph 14 of the standard as:

... the enterprise will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation.

SAS 130 (ICAEW 1994) refers to the definition in SSAP No 2 and elaborates on it as follows:

- * It recognises the going concern basis to be an accounting concept and that the assets and liabilities are recognised and measured on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business (par 5).
- * It does not specify a minimum length of period for the foreseeable future because of certain factors influencing the length of period. The factors are the entity's reporting and budgeting systems and the nature of the entity (its size and complexity) and also because in reality there is no 'cut-off point' (par 13).

2.3.4 Definition of the Canadian Institute of Chartered Accountants

CICA Handbook Section 1000.58 (CICA 1996) states the following:

Financial statements are prepared on the assumption that the entity is a going concern, meaning it will continue in operation for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of operations. Different bases of measurement may be appropriate when the entity is not expected to continue in operation for the foreseeable future.

Section 5510 (CICA 1989) provides little elaboration on this definition. Paragraph 52 lists a few examples of contrary evidence that may cast doubt on an entity's continuance as a going concern.

2.3.5 Definition of the Australian Accounting Research Foundation

AAS 6 (AARF 1995) describes the going concern basis as meaning the following:

... the accounting basis whereby in the preparation of the financial report the reporting entity is viewed as a going concern: that is, the entity is expected to

- (a) be able to pay its debts as and when they fall due; and
- (b) continue in operation without any intention or necessity to liquidate or otherwise wind up its operations.

AUS 708, paragraphs 3 and 6 (AARF 1996) refers to the definition in AAS 6 and further states the following:

- * It does not apply to financial statements prepared on a liquidation basis (par 1).
- * The entity will be able to realise its assets and extinguish its liabilities in the normal course of business (par 7).

- * Management must take all relevant information into account when deciding whether to use the going concern basis in the preparation of the financial report (par 9).
- * This requires management to consider a future period but does not specify a standard length for this period because of certain factors influencing the length of period. The factors are the entity's reporting and budgeting systems and the nature of the entity (its size and complexity) and also because in reality there is no 'cut-off point' (par 9).

2.3.6 Definition of the South African Institute of Chartered Accountants

AC 000, *Framework for the preparation and presentation of financial statements* (SAICA 1990a), defines the going concern assumption in paragraph 23 and AC 101 (SAICA 1999) elaborates on management's responsibility for assessing the going concern assumption in paragraphs 24 and 25. The definition and management's responsibility as set out in these documents are, in all respects, exactly the same as the definition and responsibilities supplied by IFAC (see sec 2.3.1).

2.3.7 Summary of the definitional issues

The decision whether an entity complies with the going concern assumption is subjective and dependent on management's or the individual auditor's judgement. Some of the accounting standards assume continuity in the absence of information to the contrary and describe what a going concern is *not* rather than what it is. If the entity has the intention of

liquidation, it is not a going concern, or if the entity is not able to realise its assets and discharge its liabilities in the normal course of business, it is not a going concern.

Some of the accounting standards, namely IAS 1 (IFAC 1997b), SSAP 2 (ICAEW 1971), AAS 6 (AARF 1995) and AC 101 (SAICA 1999) use liquidation or material curtailment as the criteria for an entity to be a nongoing concern. Auditing statements, SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996), differ in this respect that they specifically exclude liquidation and thus require the auditor to determine, prior to the entity going into liquidation, whether it is a going concern or not. Ng (1990:7) explains this as follows:

The use of the material curtailment and inability to realise assets/discharge [sic] in the normal course of business criteria place the other guidelines in the same position as SAS 59 in that material curtailment of operations and inability to realise assets/discharge liabilities may occur at a point in time before the liquidation date. However, the contemporaneous use of liquidation as an alternative criterion means that auditors may not need to evaluate an entity to ensure its ability to continue in business until the ultimate and definite occurrence of liquidation.

This means that at a point in time before liquidation the entity may be a nongoing concern and should be evaluated as such by the auditor in terms of SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996).

Terms such as 'materially', 'significantly' and 'substantially' are not defined in the accounting or auditing standards associated with the going concern assumption. It is left to the discretion of the auditor to decide when an entity has materially or significantly curtailed its operations, or when an entity has substantially disposed of its assets outside the ordinary course of business, restructured its debt, or had externally forced revisions

of its operations.

Ng (1990:7) considers the issue of material/significant curtailment of operations in the ordinary/normal course of business as being vague:

- * The base from which to measure the material/significant curtailment is not specified and therefore the auditor can measure it in terms of any accounting or nonaccounting criteria, such as sales, assets, employee costs or number of employees.
- * The auditor has to judge if the material/significant curtailment results in more effective/efficient production or in the entity's continued existence being questioned.
- * With the trend towards diversification of businesses, ordinary or normal is less clear-cut.

Most of the definitions refer to the entity to continue in operation for the foreseeable future or place a responsibility on the management to assess the continuity of the entity for the foreseeable future. SAS 130 (ICAEW 1994) does not specify a minimum length of time for the foreseeable future since in reality there is no cut-off point as per the statement and it depends on certain factors which will be different for every entity. For the same reasons does AUS 708 (AARF 1996) not supply a standard length of time for the foreseeable future. It does, however, draw a distinction between circumstances that may face an entity during a relevant period and events that may occur after that time. A relevant period is defined as a period of approximately 12 months from the date of the auditor's current report to the expected date of the next auditor's report. IAS 1 (IFAC 1997b) and AC 101 (SAICA 1999) regard the foreseeable future as representing a period of at least, but not limited to, 12 months from the balance sheet date.

SAS No 59 (AICPA 1988b), however, limit the foreseeable future to a period not exceeding one year beyond the date of the financial statements. This correlates with the conclusion that Ng (1990:6) came to, namely, that the inclusion of a time frame eases the auditor's job and reduces the audit risk. It ensures that auditors deal only with existing conditions and that the audit is not a prediction of the entity's ability to continue as a going concern in the future. SAS No 59 (AICPA 1988b) specifically mentions the following in paragraph 04:

The auditor is not responsible for predicting future conditions or events... Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern.

Compared to the other countries' statements on the definition of the going concern assumption, AC 101 (SAICA 1999) appears to be similar. Liquidation is used as the criterion for an entity to be a nongoing concern, while it may in fact become a nongoing concern some time before liquidation. AC 101 (SAICA 1999) is also vague about the meanings of *significantly* curtailing the scale of its operations.

The disclosure of the going concern assumption in the financial statements, as defined in the above-mentioned statements, is discussed in the next section.

2.4 DISCLOSURE OF THE GOING CONCERN ASSUMPTION IN THE FINANCIAL STATEMENTS

Accounting standards do not address financial statement disclosures about going concern problems in detail. As mentioned in the previous section, not one of the countries has an accounting standard dealing specifically with the going concern concept (see sec 2.3). In his assessment of existing accounting standards governing going concern uncertainties, Boritz (1991:61) concluded that because of the absence of guidance in these standards:

- * there is a great deal of variability in the disclosures provided;
- * the disclosures are incomplete and difficult to understand; and
- * worst of all, the frequency and timeliness of "going concern" disclosures are inadequate. Typically, there are no indications at all of the existence of any doubts about the "going concern" assumption in circumstances that, in hindsight, most required such warnings.

The auditing standards require the auditor to consider the adequacy of financial statement disclosures about going concern problems. As such these standards provide guidance on what financial statement disclosures should be made. The accounting treatment and disclosures related to the going concern assumption will depend on whether the going concern assumption is valid, questionable or invalid.

2.4.1 If the going concern assumption is valid

The effect of all the definitions on the going concern is that, if the going concern assumption has been followed in preparing the financial statements and is valid, disclosure of this fact is not required because it is presumed. According to IAS 1 (IFAC 1997b) and AC 101 (SAICA 1999) management

must follow an active approach in assessing whether the entity is a going concern. The only time that management can follow a passive approach assuming continuity, is when an entity has a history of profitable operations and ready access to financial resources.

Owing to the evolution of corporate governance, the directors of affected companies are now required to make a statement that they are of the opinion that the going concern assumption is appropriate. The statement could be part of either the director's report, the statement on corporate governance, or the statement of the directors approving the annual financial statements. The guide issued on corporate governance, *Guidance for directors: going concern and financial reporting* (SAICA 1997b), supplies the following examples of the statement that the directors should make in the financial statements in paragraph 25:

"After making all necessary enquiries the directors have no reason to believe that the company will not be a going concern in the period to the date of the next financial statements. For this reason they continue to adopt the going concern basis in preparing the annual financial statements."

OR

"After making all necessary enquiries the directors believe that the company will be a going concern in the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements."

If an uncertainty exists but the auditor concludes that the going concern assumption is **valid** as a result of management's plans to deal with the adverse effects of the uncertainty, there are certain disclosures that must be made in the financial statements according to the auditing statements. These disclosures include matters such as the following:

- * principal conditions and events that caused the doubt (SAS 59; AUS 708)
- * possible effects of such conditions and events (SAS 59)
- * management's evaluation of the significance of those conditions and events (AUS 708)
- * mitigating factors (ISA 570; SAS 59; AUS 708)
- * management's plans (ISA 570; SAS 59; AUS 708)

2.4.2 If the going concern assumption is questionable

If the going concern assumption becomes substantially or significantly uncertain but not invalid, then it may be used as a basis for preparing the financial statements. However, the uncertainty should be disclosed then in the financial statements according to the auditing standards and the accounting standards, IAS 1 (IFAC 1997b) and AC 101 (SAICA 1999). The auditing guidelines require the following disclosures:

- * principal conditions and events that caused the doubt (SAS 59; ISA 570; SAS 130; AUS 708; AU 294)
- * possible effects of such conditions and events (SAS 59; AU294)
- * management's evaluation of the significance of those conditions and events and any mitigating factors (SAS 59; AU 294)
- * assumptions adopted by the directors/management (SAS 130)
- * possible discontinuance of operations/inability to realise its assets and discharge its liabilities in the normal course of business (SAS 59; ISA 570)
- * management's plans (SAS 59; SAS 130)

- * information on or adjustments to the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities (SAS 59; ISA 570; AUS 708)

The statement of Canada does not define any disclosures that should be made, but states only that the auditor should consider the adequacy of disclosures in the event of an uncertainty. The requirements for disclosure under a going concern uncertainty of SAS No 59 (AICPA 1988b), are the most exhaustive compared to the other standards.

The guide issued on corporate governance, *Guidance for directors: going concern and financial reporting* (SAICA 1997b:7), provides an example of uncertainty in cases where there was a breach of loan covenants, and related negotiations with the providers of finance have not been completed. The directors should therefore provide the following disclosure in the financial statements:

"The company is in breach of certain loan covenants at its balance sheet date and, as such, the company's bankers could recall their loans at any time. The directors continue to be involved in negotiations with the company's bankers and, as yet, no demands for repayments have been received. The negotiations are at an early stage and, although the directors are optimistic about the outcome, it is as yet too early to make predictions with any certainty.

In the light of the actions to raise additional capital described elsewhere in the annual report, the directors consider it appropriate to adopt the going concern basis in preparing the annual financial statements."

2.4.3 If the going concern assumption is invalid

If the going concern assumption is invalid, conventional financial reporting and historical cost valuation should not be used; instead an appropriate disclosed basis of accounting should be used to prepare the financial statements. IAS 1 (IFAC 1997b) and AC 101 (SAICA 1999) require further that the reason why the entity is not considered to be a going concern should also be disclosed.

The Accountants International Study Group (AISG 1975) compiled a report on Going Concern Problems in Canada, the United States and the United Kingdom. According to this report a different basis of valuing the assets and liabilities should be used when an enterprise is no longer a going concern. Each item should be reflected at break-up or liquidation value. The auditing statements reiterate this by stating that the amounts and classification of assets and liabilities in the financial statements may need to be adjusted if the going concern assumption is unjustified, and that the possibility of additional liabilities accruing should be considered [AUS 708 (AARF 1996:7-8); ISA 570 (IFAC 1995:4)].

The significant differences between financial statements prepared on a going concern basis and those prepared on a liquidation basis can be seen in table 2-1, drawn from the report on Going Concern Problems (AISG 1975:48). The break-up or liquidation values as indicated in table 2-1 are usually associated with voluntary or orderly liquidation, which implies an orderly cessation of operations and the sale of assets in a manner intended to maximise the value of the firm to the shareholders. This is in contrast to involuntary liquidation, which may involve the selling of the enterprise's assets at distressed prices to settle the claims of creditors (Nogler & Schwartz 1989).

TABLE 2-1

COMPARISON OF VALUATION ALTERNATIVES

	GOING CONCERN BASIS	LIQUIDATION BASIS
Fixed assets such as land, buildings, plant & machinery, motor vehicles, etc	At cost (or valuation, in the UK) less accumulated depreciation to write down to estimated residual value over the estimated useful life. The net book amounts do not purport to represent realisable values.	At estimated realisable values on a "break-up" basis.
Inventories	At the lower of cost and "market" (as the term is used in the three nations) in the ordinary course of trade.	At estimated realisable value on a "break-up" basis which will almost always be much less than in the ordinary course of trade.
Accounts receivable	At the amount of the debts less provision for doubtful accounts.	At the amount of debts less any contingent or other claims which can be set-off and less provision for doubtful accounts.
Deferred costs and prepaid expenses	Carried forward as assets to match against future revenues.	Normally excluded as of no value.
Investments long-term	At equity or cost, unless value permanently impaired.	At market value.
Investments short-term	At lower of cost or market value (sometimes just at market value).	At market value.
Liabilities	Order of ranking not disclosed except that secured liabilities are shown as such. No provision for additional liabilities which would emerge if the enterprise were to cease operations.	Secured creditors and preferential creditors ranked in appropriate order against assets. Full provision for additional legal liabilities on cessation, which may include: unfunded vested portion of pension plan, severance or redundancy payments and claims for breach of contracts, eg leases.

Source: AISG (1975:par 48).

2.4.4 Summary of the disclosure requirements

According to the professional accounting and auditing standards, disclosure of the going concern assumption in the financial statements is not necessary when it is valid, because it is presumed. However, the guidelines issued on corporate governance require directors of affected companies to make a statement to the effect that the going concern assumption is valid.

If the going concern assumption is valid as a result of management's plans or if it becomes questionable, certain disclosures must then be made in the financial statements.

If the going concern assumption is invalid, then the financial statements should be prepared on a liquidation basis. Some accounting standards require further that the reason why the entity is not considered to be a going concern should also be disclosed.

However, the point in time at which it becomes necessary for an entity to give note disclosure about the risks and uncertainties of the going concern assumption being questionable or to abandon the historical cost basis of accounting in favour of realisable and liquidation values due to the going concern assumption being invalid, is not clear-cut. It should be judge by the preparers of the financial statements and the auditors.

The auditing guidelines require the auditor to consider the adequacy of financial statement disclosures about going concern problems and therefore provide details about what disclosures are required. The accounting standards, however, do not provide any guidance on proper presentation and disclosure of going concern problems. The link between accounting

standards and audit responsibility is thus not bridged. The accounting guidelines issued on corporate governance do provide guidance on the presentation and disclosure of the going concern assumption.

The point in time at which the going concern assumption becomes questionable can be associated with financial distress and the point in time at which the going concern assumption becomes invalid can be associated with business failure which consists of typical stages. These are discussed in the next section.

2.5 THE GOING CONCERN ASSUMPTION AND ITS RELATION TO FINANCIAL DISTRESS AND BUSINESS FAILURE

2.5.1 Description of terms

According to Boritz (1991:17), the going concern assumption becomes questionable if an entity is in financial distress and invalid sometime before liquidation, which is the final stage of business failure. Sometime before business failure, the entity will show signs of financial distress.

According to Boritz (1991:23) financial distress can be defined as: 'A general state of being under financial pressure due to a mismatch of cash inflows and outflows, cash shortage brought on by customer payment defaults, poor cash flows from operations, and so on.'

Business failure has been defined in various studies (Beaver 1966:71; Boritz 1991:23; Bureau of Financial Analysis 1981:10) as the *inability of an entity to pay its financial obligations as they mature*. According to Boritz (1991:22), ‘... events such as insolvency, receivership and bankruptcy are preferred as being more objective indicators of the failure of a business by providing de facto evidence that the “going concern” assumption is invalid.’

Table 2-2 defines some of the terms associated with business failure.

2.5.2 The stages of business failure

Since business failure is a process which often takes years to unfold (Argenti 1983), it is difficult to determine the exact point in time when an entity ceases to maintain its going concern status. Robertson (1983:25) analysed a group of failing companies and found that 60% of them showed substantial changes in financial health, some a full ten years before failure. Argenti (1983:73) classifies the failure process typically to take five years to unfold. During this time, warning signs will indicate that the entity is approaching a state of severe financial distress or even business failure. This affords the management of the entity and the auditor the opportunity to observe and evaluate the warning indicators and assess their impact on the validity of the going concern assumption in the foreseeable future.

TABLE 2-2

TERMS ASSOCIATED WITH BUSINESS FAILURE

Bankruptcy: a legal recognition of the state of insolvency, brought on for the benefit of, or by, creditors with unsecured debts that were not paid according to agreed-upon terms. Voluntary bankruptcy involves an assignment of assets by the debtor for the benefit of the creditors. Involuntary bankruptcy is initiated by a petition by an unsecured creditor which, if effected, results in a receiving order made by the Court.

Insolvency: the inability of a debtor to pay obligations as they mature or come due because of an inability to raise cash by whatever means possible. Insolvency may be a temporary condition, due to a mismatch between cash inflows and cash outflows, although it is often the immediate cause of formal bankruptcy proceedings. Insolvency in the context of bankruptcy is a condition when an entity's total debts exceed the liquidation value of its assets.

Liquidation: may be voluntary or involuntary. Orderly liquidation involves the sale of an entity's assets in an unhurried manner, taking time, for example, to search out all potential buyers, waiting until market downturns reverse themselves, and so on. In some cases, however, liquidation may also involve the piecemeal sale of an entity's assets at a point in time without regard to the potential benefits of waiting until markets improve.

Receivership: arrangement whereby a receiver is appointed to act on behalf of the creditors, usually with secured debt, and whose debts were not paid according to agreed-upon terms or when there is a risk the creditors' position will deteriorate due to an entity's financial distress.⁴

Source: Boritz (1991:23)

⁴ In the Republic of South Africa, a company is placed under 'judicial management' if there is a possibility that its solvency can be rectified, otherwise it is placed under liquidation. In South Africa it is only in rare and isolated cases that a company is placed under 'judicial management'.

Boritz (1991:17) divides the business failure process into typical stages namely the incubation stage, the severe cash shortage stage, the management attempt rescue actions stage, the rescue attempts fail stage, and finally the failure stage, which entails the bankruptcy and liquidation of the entity. These typical stages of business failure are illustrated in figure 2-1.

2.5.2.1 The incubation stage

The incubation stage represents poor management and adverse economic conditions which can result in the entity making costly errors and therefore putting itself in a position of financial distress (Boritz 1991:17).

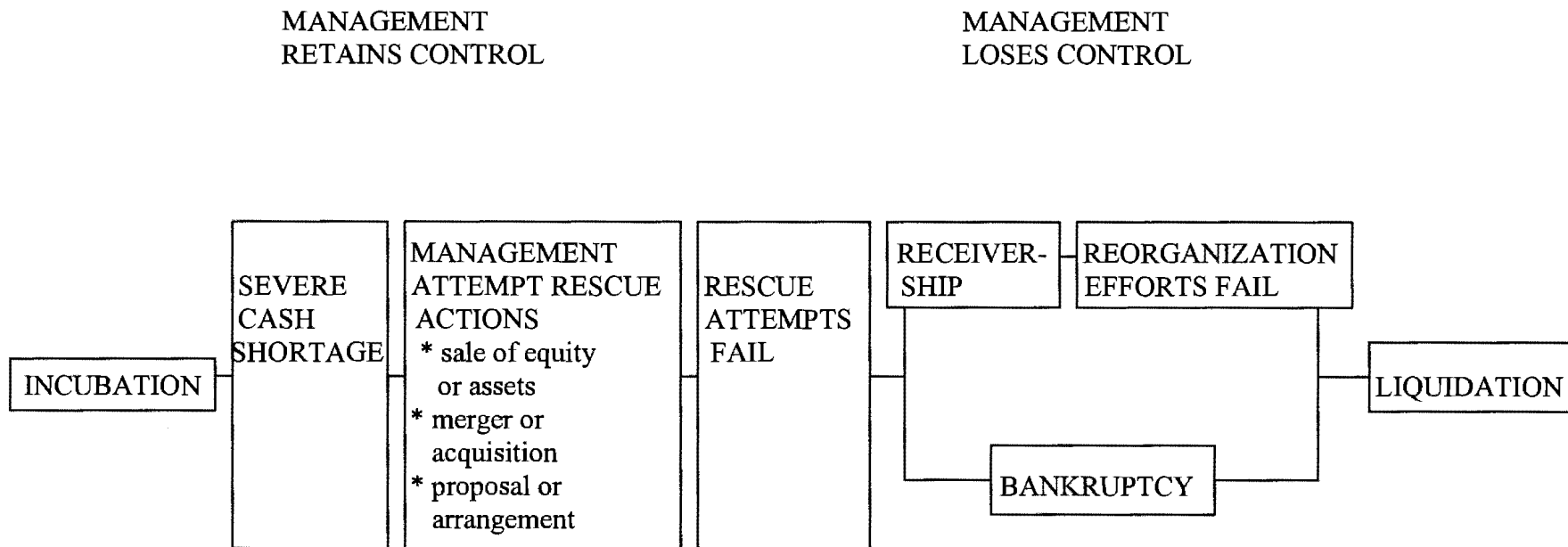
Poor management has been cited as the initial cause for business failure (Andrews 1979; Argenti 1983; Norgard 1987). Argenti and Norgard define poor management as stemming from:

- * an autocratic chief executive
- * an inadequate management depth
- * an unbalanced administrative team
- * an uninvolved board
- * a weak finance function, that is the lack of proper financial information such as budgetary control systems, cash flow planning and costing systems

Argenti (1983) and Norgard (1987) also cite the following as a cause of business failure: adverse economic conditions and the entity's failure to observe them, to regard them as significant, or to respond to them by taking appropriate action. Adverse economic conditions represent changes in technology and markets and other competitive factors, such as loss of a

FIGURE 2-1

TYPICAL STAGES OF BUSINESS FAILURE



Source: Boritz (1991:18)

key franchise, larger companies moving in to the field and if the cost of a major new product substantially exceeds projections.

With this background, the entity is now poised to make a costly error or errors. According to Argenti (1983) there are three errors:

- (1) overtrading = an entity expands too quickly and borrow to meet its increased cash needs
- (2) high gearing = bank borrowing/other loans become too great a burden on its profits
- (3) the big project = an entity launches a project of such a magnitude that when it goes wrong, the company is financially crippled

Poor management, adverse economic conditions and costly errors are all indicators that may cause doubt about the entity's ability to continue as a going concern. Norgard (1987:24) divides these indicators, which are identified in the literature as being effective early warning signs that an entity might be approaching a state of severe financial distress or even business failure, into two groups:

Operational indicators

- * overtrading
- * margin erosion
- * the big project
- * high gearing
- * corporate inertia
- * changes to the business
- * problem borrowing
- * decline in service standards

- * undercapitalisation
- * too much easy money
- * history of continuing losses

Accounting indicators

- * financial ratios
- * lack of cash flow forecasting
- * lack of financial information
- * creative accounting

Some of these indicators are direct causes of business failure while others are merely symptoms of the causes. Examples of causes of business failure are poor management, lack of cash flow forecasting and financial information, defective response to change, overtrading, and high gearing (Argenti 1983:67). These causes are identified and discussed throughout the business failure process in the next section (see sec 2.6).

Argenti (1983:67) classifies deteriorating financial ratios, creative accounting and nonfinancial signs, such as declining service standards and a declining market share, as symptoms of business failure that do not provide insight into the causes of business failure. Because of the effect of creative accounting⁵, which has been identified as a warning signal of failure (Jones 1992:21; Norgard 1987:25), financial ratios are likely to become less reliable as failure approaches (Keasy & Watson 1987:336). However, Boritz (1991:25) points out that these indicators are still valuable:

⁵ Creative accounting is a practice followed by the management of an entity in an attempt to hide the poor financial condition of the company from outside investors and creditors by manipulating the accounts.

Despite being indirect, indicators reflecting symptoms are valuable since it is often difficult to observe the indicators representing causes directly or accurately until it is too late to do anything about them. Thus, it is often necessary to draw inferences about underlying conditions by observing only external symptoms of those conditions.

The professional auditing standards divide these warning signs that continuance as a going concern should be questioned, into financial indicators, operating indicators and other indicators, and provide a few examples [ISA 570 (IFAC 1995:6); SAS 130 (ICAEW 1994:31); AUS 708 (AARF 1996:appendix 2); AU 294 (SAICA 1986:8)]. SAS No 59 (AICPA 1988b), paragraph 6 divides them into financial matters (negative trends and other difficulties), internal matters and external matters. The indicators provided by the auditing standards and the auditor's responsibility to evaluate it are discussed in the next chapter (see sec 3.4.2).

2.5.2.2 The severe cash shortage stage

The incubation stage is followed by the severe cash shortage stage, which is a result of the incubation stage. The entity is now in *financial distress* and the going concern assumption becomes questionable.

2.5.2.3 The management attempt rescue actions stage

A severe cash shortage leads to management attempting rescue actions. This stage represents management's plans to overcome the entity's problems. These plans may include, say attempts at new borrowings, restructuring of debt, reducing wages, selling productive assets or participation in a merger or other form of acquisition (Pastena & Ruland 1986:288).

The professional auditing standards give examples of these plans to mitigate the adverse effects of the conditions and events that lead inter alia to the entity facing a severe cash shortage [AU 294 (SAICA 1986:10); AUS 708 (AARF 1996:appendix 3); ISA 570 (IFAC 1995:7); SAS No 59 (AICPA 1988b:7)]. The statements divide these plans into:

- * plans to dispose of assets
- * plans to borrow money or restructure debt
- * plans to reduce or delay expenditures
- * plans to increase ownership equity

The management plans provided by the auditing standards and the auditor's responsibility to evaluate them, are discussed in the next chapter (see sec 3.4.4).

Nine out of 15 auditing partners interviewed in a research study indicated that management's plans to borrow money or restructure debt and plans to reduce or delay expenditures are of vital importance, because generally, the benefits are realised most quickly. The economic benefits derived from plans to dispose of assets and plans to increase ownership equity usually require more time. (Williams 1984:16).

These plans of management are regarded as rescue actions outside the normal course of operations and are warning signs of business failure. If there is a high probability that these actions will succeed, then the degree of doubt raised about the going concern assumption under the cash shortage stage will be reduced. If there is a moderate or low probability that these actions will succeed, then the degree of doubt will increase, resulting in substantial doubt.

Up to this point, according to Boritz (1991:17), management retain control over their assets and operations by the successful implementation of actions to rescue the entity from financial distress.

2.5.2.4 The rescue attempts fail stage

If management's rescue attempts fail and they lose control (or are likely to lose control in the next financial year) over the entity's assets and operations to a lender or other creditors through the formal appointment of a receiver or a less formal involvement by a consultant or monitor, there is very substantial doubt about the validity of the going concern assumption (Boritz 1991:17).

2.5.2.5 The failure stage

When management lose control (or is likely to lose control in the next financial year) over the entity's assets and operations to a trustee in bankruptcy, the going concern assumption is invalid and an alternative basis of accounting should be used. Although it is sometimes possible for an entity to avoid bankruptcy through an effective reorganisation plan, it still faces a high risk of bankruptcy and liquidation. (Boritz 1991:17.)

2.5.3 Summary of the going concern assumption and its relation to financial distress and business failure

Business failure develops over time and does not occur without warning. Long before the actual cessation of operations, an entity will show warning signs of financial distress or impending failure. Poor management has been cited as the initial cause of business failure. The auditor should be

able to recognise these warning signs and evaluate their impact on the going concern concept to judge if the entity will be able to continue as a going concern in the foreseeable future. By bringing warning signs to the attention of management and shareholders early enough potential significant losses can be reduced or avoided (Boritz 1991:21).

Business failure proceeds through identifiable stages, which result in the going concern concept being questionable or invalid at a certain stage. If the entity is unable to meet its obligations in the current financial year or in the next financial year, without initiating actions outside the ordinary course of operations to rescue the entity from financial distress or insolvency, the auditor should question the appropriateness of the going concern concept used in the financial statements (Boritz 1991:33). Actions outside the ordinary course of operations include management's plans to dispose of assets, borrow money or restructure debt, reduce or delay expenditures or increase ownership equity.

2.6 CONCLUSION

This chapter has indicated that the going concern assumption is one of the fundamental accounting concepts underlying the preparation of the financial statements in accordance with generally accepted accounting principles.

An examination of the various definitions of the going concern assumption in the professional standards have revealed that basically the going concern assumption means that it assumes that an entity will continue in operation for the foreseeable future and will be able to realise its assets and discharge its liabilities in the normal course of business. However, the evolution has indicated that as early as 1968/1972 researchers concluded that the continuity of a client should not be assumed by the accountant but that it should be investigated by the accountant. It was only in 1988 that the first professional auditing standard and in 1997 that the first accounting standard were amended to ensure that the accountant and auditor evaluates the going concern assumption and does not merely assume it (see sec 2.3.1 and 3.2.1).

This chapter has examined the guidance provided by existing professional standards on the disclosure of the going concern assumption in the financial statements. Existing accounting standards do not provide detailed guidance to the preparers of financial statements or to auditors of disclosures that should be made in the financial statements when the going concern assumption is valid as a result of management's plans or when it is doubtful. The auditing standards do provide extensive guidance to the auditor in this respect. However, for an auditor to decide if an entity complies with the going concern assumption is subjective and dependent on his or her judgement.

It has also been demonstrated in this chapter that when the going concern assumption becomes questionable it can be associated with financial distress and when it becomes invalid it can be associated with business failure. Business failure is a process, which proceeds through different stages. Long before the actual business failure, the entity will show warning signs or indications of going concern problems, which indicate

that the entity is approaching a state of severe financial distress. During the business failure process, various attempts will be initiated by management to rescue the entity. The auditor should be able to recognise and evaluate the impact of the warning signs on the going concern concept and the rescue attempts of management during these stages in order to judge if there is substantial doubt about the entity's ability to continue as a going concern in the foreseeable future or if the situation is alleviated.

There are different levels of substantial doubt, depending on the probability that the rescue attempts of management will/will not succeed.

The next chapter assesses whether or not the auditing statements provide sufficient guidance to the auditor in his or her responsibility to evaluate and report on the going concern assumption.



CHAPTER 3

THE GOING CONCERN ASSUMPTION IN THE CONTEXT OF THE PROFESSIONAL AUDITING STANDARDS

3.1 INTRODUCTION

Mautz and Sharaf (1961:42) incorporated the going concern assumption as one of the postulates in auditing, namely: 'In the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future.' They explained that the inclusion of the going concern assumption as an auditing postulate is necessary because it, together with other postulates, provides the basis for a logical, integrated theory of auditing, and that without the going concern assumption of accounting, auditing would be 'improbable, if not impossible' because:

Unless the auditor can assume that what has held true in the past will hold true in the future for the enterprise under examination, barring any clear indications to the contrary, he has no basis for accepting or rejecting such assertions as the valuation of receivables and inventories, the economic usefulness of fixed assets, or the adequacy of internal control (Mautz & Sharaf 1961:49).

Mautz and Sharaf (1961) recognised that the going concern assumption of accounting was encompassed by the auditing postulate, but believed that the postulate added something more, namely:

- * It provides the auditor with a guide in the performance of all his verification work. For example, if fixed assets are purchased to facilitate a certain type of activity, which has been conducted according to plan, the auditor, in the absence of contrary evidence, can expect the activity to continue and the assets to be used.
- * It places important limits on the extent of an auditor's responsibilities.
- * It provides a basis for reducing the extent of an auditor's obligation to forecast the future and to have his work judged on the basis of hindsight.

The going concern assumption therefore has significant effects on the auditor. Chapter 2 concluded that the auditor must apply his judgement to decide whether an entity is a going concern and that the accounting standards do not provide sufficient guidance in this respect. The objective of this chapter is to peruse existing auditing standards in order to:

- * summarise the evolution of the going concern assumption in auditing
- * outline the requirements of the professional auditing standards regarding the auditor's
 - responsibility to evaluate a client's continued existence
 - responsibility to report on a going concern problem
- * assess the approach that the standards advocate the auditor should follow in the evaluation
- * identify the indicators of going concern problems supplied by the standards

- * identify the audit procedures that the standards prescribe the auditor should follow in the evaluation
- * assess the auditor's responsibility to evaluate management's plans for dealing with the going concern problem
- * establish if the auditing standards provide sufficient guidance to the auditor in his evaluating and reporting responsibility

3.2 EVOLUTION OF THE GOING CONCERN ASSUMPTION IN AUDITING

Prior to 1962 the impact of going concern problems received little attention in the professional standards. The necessity for and the wording of the going concern report were left to the discretion of the individual auditor (Asare 1990:40). Taffler and Tisshaw (1977:50) also emphasised this:

... when it comes to the critical decision of whether to qualify a report for going-concern reasons, the auditor is still very much on his own, having to rely virtually entirely on his subjective judgement and experience. ... the accountancy bodies have made virtually no pronouncement on what constitutes a going concern, nor does there seem to have been any legal guidance.

The American Institute of Certified Public Accountants (AICPA) seems to be the officiator in the evolution of the auditing statements dealing with the auditor's responsibilities regarding the going concern. They were always first with new pronouncements on this subject, followed by the International Federation of Accountants (IFAC) and the other English-speaking countries discussed in this dissertation. Thus the following discussion on the evolution of the going concern assumption is in the

context of the United States of America with a brief exposition at the end on its evolution in South Africa.

3.2.1 Evolution of the going concern assumption in the United States of America

The first professional pronouncement on the going concern subject occurred in March 1962. The Securities and Exchange Commission (SEC) issued Accounting Series Release (ASR) No 90 - *Certification of income statements*, which stated that a 'subject to' qualification in the audit report would be appropriate in situations where the outcome of a matter, transaction or event is uncertain (Asare 1990:40).

The auditing profession followed suit, with the AICPA Auditing Standards Board issuing the Statement on Auditing Procedures (SAP) No 32 - *Qualifications and disclaimers*. SAP No 32 differentiated between a 'subject to' qualification and an 'except for' qualification and recommended that the former be used in situations where the outcome of a matter is uncertain. However, the wording of the statement was such that the auditor could choose either qualification resulting in the improper use of the 'subject to' qualification. For example, in cases of inadequate disclosure of conditions involving uncertainty, auditors used the 'subject to' qualification instead of the 'except for' qualification. (Konrath 1985:132.)

The AICPA attempted to restrict the improper use of the 'subject to' qualification in 1973 by issuing Exposure Draft of Statement on Auditing Standards (SAS) No 2 - *Reports on audited financial statements*. The Exposure Draft proposed to replace the 'subject to' phrase with 'except for', for qualifications based on uncertainties. However, the proposal was not adopted because, among other reasons, the practitioners wanted to reserve the 'except for' qualification for situations of disagreement between the auditor and management. (Landsittel & Serlin 1982:250.)

SAS No 2, which was issued in 1974, was the first formal standard requiring the auditor to consider the recoverability and classification of recorded assets and liabilities when considering the possibility that the entity may not be a going concern. The statement advised auditors to consider qualifying their report or issuing a disclaimer of opinion in cases of material uncertainties and limited the use of the 'subject to' qualification to such cases. (Asare 1990:41; Konrath 1985:132.)

In the period that followed, the 'subject to' qualification became a controversial topic, with numerous attempts to eliminate it. Bankers and analysts (users of financial statements) were against the elimination. They argued that the 'subject to' qualification provides an early warning signal for more extensive analysis of the financial statements and that the elimination of the 'subject to' qualification would:

- * effectively eliminate an important 'red flag' for investors, as auditors have access to inside information upon which the going concern qualification is based
- * force an auditor to render an unqualified opinion where he continued to have serious reservations about the financial position of an entity (Landsittel & Serlin 1982:251).

Not all auditors, on the other hand, agreed on the need to have a reporting responsibility for disclosing going concern uncertainties and they were opposed to the 'subject to' qualification. The Commission on Auditors' Responsibilities (CAR) summarised the opposition to the 'subject to' qualification. They stated that the going concern 'subject to' qualification was misinterpreted by users who view it as a prediction of liquidation and that unqualified opinions (the absence of 'subject to' qualifications) create the impression that entities will continue as going concerns. According to the CAR, disclosure in or adjustment of the financial statements is a better way of communicating an uncertainty compared to an audit report qualification, and it recommended the elimination of the 'subject to' qualification. (CAR 1978:30.)

In response to this recommendation, the AICPA issued an exposure draft in 1977, *Auditors' report when there are contingencies*, which complied with the Commission's recommendation to eliminate the 'subject to' qualification for all types of uncertainties, including the going concern uncertainty, and when necessary to replace it with note disclosure. If the note disclosure regarding the uncertainty was adequately set forth, in accordance with criteria in the Financial Accounting Standards Board (FASB) Statement No 5 - *Accounting for contingencies*, then no audit report qualification or modification was necessary according to the exposure draft. If the disclosures were not adequate, an 'except for' or adverse opinion was required. For various reasons this proposal was not adopted. There was user opposition from the SEC and various commentators. (Landsittel & Serlin 1982:251.)

In 1980¹ the Auditing Standards Board issued an exposure draft entitled *The auditor's standard report*, which attempted to modify the standard audit report without eliminating the 'subject to' opinion. However, it also failed to pass. Another working draft, entitled '*Matters involving uncertainties*', was prepared in 1982 and it became the focus of a public meeting to consider elimination of the 'subject to' opinion on 20 June 1983. Strong user opposition was expressed at the meeting and the project was sent back for study without the issuance of an exposure draft. (Robertson 1988.)

In March 1981 the AICPA Auditing Standards Board issued SAS No 34, *The auditor's considerations when a question arises about an entity's continued existence* (AICPA 1981). SAS No 34 (AICPA 1981) provided guidance to the auditor on how to evaluate potential going concern problems and was an improvement on the mere requirement of SAS No 2, to consider the recoverability and classification of recorded assets and liabilities in the presence of going concern uncertainties (Asare 1990).

SAS No 34 (AICPA 1981) required the auditor to be aware that the audit procedures performed in the normal course of the audit may uncover information contrary to the going concern assumption. Contrary information may be solvency problems, operating problems or other internal/external problems (see sec 2.5.2.1). SAS No 34 thus adopted a passive approach in that it did not impose a responsibility on auditors to search for evidence about the continued existence of the client. This

¹ In this year, the Canadian Institute of Chartered Accountants actually abolished the 'subject to' qualification for all types of uncertainties, including the going concern, as well as prescribing the use of a middle paragraph in the audit report, to call attention to the uncertainties.

contributed to the expectations gap.²

SAS No 34 (AICPA 1981) required the auditor to consider factors, which might mitigate any of the above-mentioned contrary information. Mitigating factors are management's plans to overcome these problems and can be divided into plans to dispose of assets, borrow money or restructure debt, reduce or delay expenditures, and/or increase ownership equity (see sec 2.5.2.3). If there still remains a question about the entity's continued existence after consideration of these factors, the auditor must then consider the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities.

The effect of SAS No 34 (AICPA 1981) on the auditor's report was that the auditor should modify it when substantial doubt remained about the entity's ability to continue as a going concern, but only when there is a recoverability question. The audit report should then contain a 'subject to' qualification (or a disclaimer of opinion). The 'subject to' qualification issued is thus stated in terms of recoverability and not continued existence. (Pany 1987:87.)

Under SAS No 34 (AICPA 1981) an unqualified opinion may thus be issued in the presence of going concern uncertainties if the assets and liabilities have been appropriately classified and reported on a recoverability basis. This also contributed to the expectations gap.

² 'Expectations gap' is a term used to describe the belief that users of audited financial statements misunderstand both the role of the auditor in the financial reporting process and the meaning of the audit report.

SAS No 34 (AICPA 1981) did not provide the auditor with any guidance on what decision-making criteria or process should be used for measuring such recoverability. The final decision on the going concern status of an entity was thus a matter of professional judgement by the auditor.

At this stage the auditor's role in going concern uncertainties did not meet the public's expectations, as emphasised by Conner (1986:77):

Public demands for an early warning when a business stands on the brink of failure have never been expressed so forcefully. When businesses fail a short time after an unqualified audit report is issued, what infuriates the public most is that there was not adequate warning of the failure. The public quickly characterizes such business failures as audit failures.

In a study conducted by Menon and Schwartz (1986:46) it was found that only 43 percent of 147 companies that had filed petitions for bankruptcy during 1974 to 1983 had their last audit reports that were issued, qualified for going concern reasons. Menon and Schwartz (1986:51) concluded that the implication of their study was that bankers should not rely on the auditor's report as an early-warning signal of pending failure.

Campbell and Mutchler (1988:49) conducted a research study to provide evidence on the extent to which the expectations gap existed regarding the auditor's role in the presence of going concern uncertainties, and found that:

- * 42 percent of the auditors agreed with SAS No 34 that an auditor issues a going concern audit report if there is a recoverability question
- * 49 percent of the bank lending officers wanted the auditor to issue a going concern audit report because they see it as the auditor's duty to provide them with an early-warning signal

- * 39 percent of the auditors also thought it was the auditor's duty to provide financial statement users with an early-warning signal

Campbell and Mutchler concluded that there was a demand for change in auditor responsibilities and that SAS No 34 (AICPA 1981) needed to be revised to require auditors to assess the continued existence of the entity in every audit, and to modify the audit report when there is substantial doubt.

In 1988 the Auditing Standards Board decided to revise the Statements on Auditing Standards in an attempt to eliminate the expectations gap. SAS No 34 (AICPA 1981) needed to be revised because of the:

- * question whether auditors had been taking sufficient responsibility for evaluating a client's ability to continue in existence
- * fact that more than a few companies had gone out of business shortly after the issuance of an auditor's statement that did not mention the possibility that the company might not continue (Goldstein 1989:50).

The Auditing Standards Board revised the statement on the audit report and issued SAS No 58, *Reports on audited financial statements* (AICPA 1988a). The statement prohibits the use of the 'subject to' qualification in audit reports but requires an explanatory paragraph to draw attention to going concern uncertainties disclosed in the notes to the financial statements. The red flag function of the 'subject to' opinion was thus retained in the form of an explanatory paragraph.

The Board also issued SAS No 59, *The auditor's consideration of an entity's ability to continue as a going concern* (AICPA 1988b), which replaced SAS No 34 (AICPA 1981). SAS No 34 and SAS No 59 are compared in table 3-1, which indicates that SAS No 59 (AICPA 1988b) differs from SAS No 34 (AICPA 1981) in three major respects, namely:

- (1) The auditor must now follow an active approach to evaluate the entity's ability to continue as a going concern for a reasonable period of time.
- (2) The auditor must modify the audit report when he has substantial doubt about the entity's ability to continue in existence even when asset recoverability and liability classification are not in question.
- (3) The auditor must eliminate the 'subject to' opinion and include an explanatory paragraph in an unqualified report. The explanatory paragraph must describe the uncertainty; refer to the related disclosure in the financial statements; and state that the financial statements do not include any related adjustments.

SAS No 59 (AICPA 1988b), paragraph 13, provides an example of such an explanatory paragraph:

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about the company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of the uncertainty.

TABLE 3-1
COMPARISON OF SAS NO 34 AND SAS NO 59

	SAS No 34	SAS No 59
Overall responsibility	Entity's ability to continue as a going concern is considered in an audit only when contrary information is discovered.	Entity's ability to continue as a going concern is considered in every audit. Results obtained by audit procedures are evaluated to determine going concern ability.
Cause of report modification	Questionable recovery of assets and classification of liabilities.	Inability to continue as a going concern.
Level of doubt needed for report modification	Substantial.	Substantial.
Time frame	Approximately one year.	Not to exceed one year from audited financial statements.
Effect on audit opinion	Qualified 'subject to'.	Unqualified with an explanatory paragraph following the opinion paragraph.

Source: Ellingsen, Pany & Fagan (1989:25)

SAS No 59 (AICPA 1988b) thus places more responsibility on auditors for assessing the ability of their clients to continue as going concerns. However, with the inclusion of the time frame (par 4) it ensures that auditors deal only with existing conditions over a limited period of time and that they are not responsible for predicting future conditions or events.

The results of a research study conducted by Raghunandan and Rama (1995) indicated that SAS No 59 (AICPA 1988b) succeeded in closing the expectations gap. Auditors were now more likely to issue going concern modified audit reports for financially stressed nonbankrupt companies and for bankrupt companies prior to failure in the post-SAS No 59 period than in the pre-SAS No 59 period. In contrast Carcello, Hermanson and Huss (1995) concluded that the gap between users' expectations and auditors' reporting does not seem to have been reduced. They confined their research study to the audit reports issued by the 'Big Eight'/'Big Six' audit firms and found that the propensity to modify bankruptcy-related opinions increased after the issuance of SAS No 34 (AICPA 1981), but not after the issuance of SAS No 59 (AICPA 1988b).³

SAS No 59 (AICPA 1988b) does not require auditors to perform more audit procedures than they currently do (par 5) but requires their current audit procedures to be of a sufficient nature to indicate substantial doubt about the entity's ability to continue as a going concern. However, the absence of *specific* audit procedures and guidelines to assess the going concern status of an entity is regarded as one of the shortcomings of SAS No. 59 (Koh & Killough 1990:183).

³ The difference in qualifying attitudes of auditors from 'Big Eight'/'Big Six' audit firms versus auditors from other audit firms is discussed in chapter 5 of this study (see sec 5.3.3).

Koh and Killough (1990:190) came to the conclusion that there is a need for a more objective and unambiguous approach to evaluate an entity's going concern status and saw the use of discriminant analysis and failure prediction models as possible solutions to help the auditor make such an evaluation.⁴ The auditor's examination of historical information under SAS No 59 to determine whether there is substantial doubt about an entity's ability to continue as a going concern, is regarded by McLaughlin (1990:12) as causing auditors to issue misleading audit reports and that they need a quantitative measurement for such a determination. He used a going concern value ratio conceptual model in his study and concluded that it can aid auditors in making a going concern decision (McLaughlin 1990:121).

Another shortcoming of SAS No 59 (AICPA 1988b) identified in the literature is the fact that the statement does not define *substantial doubt*. No precise meaning or value is attached to substantial doubt (Ponemon & Raghunandan 1994:46). Although SAS No 59 (AICPA 1988b) was issued to eliminate the expectations gap, the study of Ponemon and Raghunandan (1994) indicated that there is still an expectations gap between auditors and users of financial statements regarding the meaning of substantial doubt used in SAS No 59. Judges in the study perceived substantial doubt at a lower probability value than the auditors, which suggests that they believe auditors are too conservative in rendering going concern report modifications for entities with going concern problems. Bankers and financial analysts in the study perceived substantial doubt at a higher probability value than the auditors, which suggests that they believe that substantial doubt connotes greater assurance of an entity's financial demise than intended by auditors. The results of this study indicated that there is

⁴ The feasibility of auditors using statistical models to determine the going concern status of an entity is discussed in chapter 5 of this study (see sec 5.2.1).

a need for substantial doubt to be quantified in the auditing statements in clear and concise language.

The requirements of SAS No 59 (AICPA 1988b) are outlined in section 3.3.2 and compared with other auditing standards currently being followed by a number of English-speaking countries in sections 3.4 and 3.5.

3.2.2 Evolution of the going concern assumption in South Africa

In South Africa there was no formal guidance available to auditors on how to evaluate going concern problems until 1986 when statement AU 294, *Going concern* (SAICA 1986) was issued. AU 294 was issued five years after the AICPA issued their statement, SAS No 34 (AICPA 1981), on the evaluation of going concern problems.

Bosch (1984:240) identified the need for a formal guideline to auditors in South Africa on how to evaluate going concern problems:

In conclusion, it seems obvious that accountants and auditors should be provided with more definite guidelines to decide what constitutes a going-concern. It involves consequences and implications that are too grave for relying solely on the mere judgment and experience of individual members of the profession.

Statement AU 293, *Events after the balance sheet date*, issued in July 1985, was the first auditing statement that placed a formal duty and responsibility on the auditor to consider the validity of the assumption that the undertaking is a going concern (SAICA 1985a). The duty and responsibility merely involved the auditor specifically enquiring of management whether they are aware of circumstances occurring after the balance sheet date that could bring into question the going concern concept

underlying the financial statements.

The Auditing Standards Committee issued Exposure Draft (ED) 55, *Going concern*, in September 1985 (SAICA 1985b). The draft largely contained the same information that statement AU 294, issued in September 1986, contained in its final form. The only material changes made as a result of comments received were additions to paragraphs 18 and 20 of the exposure draft, regarding the effect on the auditor's report.

ED 55 (SAICA 1985b) permitted the auditor the option to issue an unqualified audit report if he concluded that the going concern concept is inappropriate (par 16) but the financial statements have nevertheless been prepared applying this concept; or if he is uncertain about the entity's ability to continue as a going concern for the foreseeable future (par 17). The only requirement was that the auditor should consider the materiality of the effect of the identified going concern problem on the values and classification of assets and liabilities (par 18).

Comments received on ED 55 (SAICA 1985b) from one auditing firm were that an unqualified opinion may be warranted only under the above-mentioned circumstances when there is adequate disclosure of the going concern problem in the financial statements, even when there is likely to be no impact on the carrying value and classification of assets and liabilities.⁵ Paragraph 18 of statement AU 294 (SAICA 1986) was changed to the effect that an unqualified opinion may be issued if there is likely to be no impact on the carrying value of assets and liabilities and there is adequate disclosure in the financial statements.

⁵ All comments that have been received on Exposure Draft 55, were reviewed by the author at the offices of the South African Institute of Chartered Accountants.

Another auditing firm commented that an unqualified opinion is never warranted under an identified going concern problem and that a qualified, adverse or disclaimer of opinion should be expressed, even when full disclosure of the circumstances and effects are made in the financial statements (see footnote 5). The option to issue an unqualified report under an identified going concern problem is thus a controversial aspect. Moir (1989:38) writes as follows on this specific aspect:

This situation clearly does not help to bridge the expectation gap. While the application of existing standards will, in the majority of instances, result in a qualified audit report where the company is not a going concern, there can be little doubt, however, that the users of financial statements would like the auditor to draw attention to the fact that a business may not be a going concern in all cases, and not only if the accounting practices had not been properly applied.

Paragraph 20 of ED 55 (SAICA 1985b) also proved to be quite controversial. Just about every comment received on ED 55 considered the inclusion of this paragraph undesirable (see footnote 5). Paragraph 20 read as follows: 'The auditor should not refrain from issuing a qualified or adverse opinion, or disclaiming an opinion, on the grounds that it may lead to the appointment of a judicial manager or liquidator.' It was felt that it should be removed since it amounts to an indictment of the integrity of the profession. No other statement reminds the auditor that he should not be influenced by the consequences of taking appropriate action and fulfilling his duty. The action taken by the Auditing Standards Committee was to add the following sentence in AU 294 to the paragraph and not to delete it (SAICA 1986): 'The auditor is not responsible for the facts that exist; he has, however, a responsibility relating to the manner in which those facts are reported.' South Africa is the only country to have such an inclusion in its auditing statements. The old auditing standard, Section 3.410 (ICAEW 1985), of the United Kingdom used to have a similar paragraph. Ng (1990:23) describes the aim of the inclusion of this paragraph in

Section 3.410, namely to advise the auditor not to use the self-fulfilling prophecy⁶ as an excuse not to qualify an entity's financial statements for going concern problems, as removing an important and controversial factor.

Other comments were received by the Committee but for the most part not acted upon (see footnote 5). Some of the comments which were not acted upon then, can now be looked upon as being shortcomings in AU 294 (SAICA 1986), because of the evolution in the auditing standards which tends to place more responsibility on the auditor for assessing their clients' continued existence. One auditing firm suggested that the auditor should consider the risk, that the going concern concept is inappropriately applied, at all phases of the audit and not only at the planning stage as stated in paragraph 07 of ED 55 (SAICA 1985b) and AU 294 (SAICA 1986) respectively. This would have resulted in an active approach being followed by the auditor throughout the entire audit. One of the regional associations wanted examples of the further audit procedures which practitioners should follow when gathering audit evidence relating to the going concern problem as stated in paragraph 09 of ED 55 (SAICA 1985b) and AU 294 (SAICA 1986) respectively. This would have provided the auditor with more definite guidelines on assessing the going concern problem.

The Auditing Standards Committee issued a new exposure draft, ED 116 *Going concern* (SAICA 1997a). ED 116 addressed the above-mentioned shortcomings, but at this stage it is on hold, awaiting the release of a new exposure draft by the International Auditing Practices Committee (see sec 3.3.1). Hence this study does not discuss ED 116 in detail.

⁶ Self-fulfilling prophecy can be described as the fear that the qualified audit report itself, rather than the entity's condition, may result in or hasten business failure (see sec 4.5.1).

The reporting responsibility that the auditor had in the presence of going concern uncertainties was outlined in auditing statement AU 321, *The auditor's report on annual financial statements* (SAICA 1982). Statements AU 321 (SAICA 1982) and AU 294 (SAICA 1986) required the auditor to issue a 'subject to' opinion in the presence of going concern uncertainties and a disclaimer of opinion if the uncertainty was fundamental. Statement AU 321 (SAICA 1982) was revised in December 1990 and differed from the above-mentioned qualification requirements in that the 'subject to' opinion was eliminated and an explanatory paragraph was included. According to AU 321 (SAICA 1990b:38) the auditor's report should be qualified in the light of an inherent uncertainty by setting out in an explanatory paragraph the circumstances giving rise to the uncertainty and the conditions which precluded the application of auditing procedures normally considered necessary. Paragraph 39 states further that an audit report, which is so qualified, may not contain an expression of an unqualified opinion on the financial statements. The required qualification (par 48) if the uncertainty is material, is 'except for', and if it is fundamental, a disclaimer of opinion is necessary.

This was in direct contrast to SAS No 59 (AICPA 1988b) which, for material uncertainties, requires an explanatory paragraph following an unqualified opinion in the audit report if it is properly disclosed in the financial statements. At this stage South Africa was also the only country that used the 'except for' qualification for uncertainties. All the other countries discussed in this dissertation reserve the 'except for' qualification for situations of disagreement only. When the AICPA wanted to use the 'except for' qualification for uncertainties in 1973, they received opposition from practitioners who wanted to reserve it for situations of disagreement only (see sec 3.2.1).

However, the revised statement AU 321 (SAICA 1990b) was replaced in November 1997 by South African Auditing Standard (SAAS) 700, *The auditor's report on financial statements* (SAICA 1997c). The reporting requirements of SAAS 700 are now in line with those of SAS No 59 (AICPA 1988b) and eliminated the 'except for' qualification for uncertainties. The auditor should issue an unqualified opinion with an emphasis of matter paragraph to highlight the going concern problem affecting the financial statements, which is included in a note to the financial statements. If the going concern problem is inadequately disclosed, the auditor should express a qualified opinion, 'except for', to indicate the disagreement with management.

The reporting responsibility of the auditor outlined in SAAS 700 (SAICA 1997c) supersedes the auditor's qualification requirements as outlined in AU 294 (SAICA 1986). The requirements of AU 294 (SAICA 1986) and SAAS 700 (SAICA 1997c) are outlined in section 3.3.6 and compared with other auditing standards currently being followed by a number of English-speaking countries in sections 3.4 and 3.5.

3.2.3 Summary of the evolution of the going concern assumption

The evolution of the going concern assumption in the United States of America has advanced to a stage where more responsibility is placed on auditors to evaluate the going concern concept in an attempt to close the expectations gap. Two shortcomings identified by the literature in the current American auditing statement are the absence of specific audit procedures to evaluate the going concern assumption and the fact that substantial doubt is not well defined in the statement.

The current auditing standard on the going concern assumption used in South Africa is currently under scrutiny to address certain shortcomings and to make it compatible with the international standards. In a study conducted by Gloeck (1993:484) 77 percent of people with financial background and 58 percent of auditors in public practice indicated that they expect auditors to do more on the going concern aspect. Gloeck concluded in his study that AU 294 (SAICA 1986) needs to be changed to close the expectations gap.

3.3 PROFESSIONAL AUDITING STANDARDS ISSUED ON THE GOING CONCERN ASSUMPTION

This section outlines the requirements of the current auditing statements of a number of English-speaking countries regarding:

- * the auditor's responsibility to evaluate an entity's ability to continue as a going concern
- * the auditor's reporting responsibility in the presence of going concern problems

These auditing statements are as follows:

- * International Standards on Auditing (ISA) 570, *Going concern* (IFAC 1995)
- * Statement on Auditing Standards (SAS) No 59, *The auditor's consideration of an entity's ability to continue as a going concern* (AICPA 1988b)

- * Statement of Auditing Standards (SAS) 130, *The going concern basis in financial statements* (ICAEW 1994)
- * Handbook, Section 5510.51-.53, *Going concern* (CICA 1989)
- * Auditing Standard (AUS) 708, *Going concern*, (AARF 1996)
- * Statement on Auditing Standards (AU) 294, *Going concern*, (SAICA 1986)
- * South African Auditing Standards (SAAS) 700, *The auditor's report on financial statements*, (SAICA 1997c)

3.3.1 Auditing standard issued by the International Federation of Accountants (IFAC)

In June 1986, five years after the American Institute of Certified Public Accountants issued their first auditing statement on the going concern assumption, IFAC issued IAG 23, *Going concern*, which was revised in 1989 in an attempt to be consistent with the AICPA's SAS No 59 (Boritz 1991:79). In 1995, IFAC issued ISA 570 which contained basically the same information as IAG 23 (IFAC 1989), with a shift of emphasis from a passive to an active approach.

According to ISA 570 (IFAC 1995), the auditor's responsibilities are as follows:

- * An active approach is adopted because the auditor should consider the appropriateness of the going concern assumption when planning and performing audit procedures and evaluating the results thereof (par 2).
- * A list of indications that the going concern assumption may be questionable is provided. The list differentiates between financial, operating and other indications (par 6).

- * If a going concern problem arises the auditor should gather sufficient appropriate evidence (evaluate information obtained earlier; employ additional audit procedures) to confirm or dispel the doubt for a period not exceeding one year after the balance sheet date (pars 8-9).
- * Examples of audit procedures that are relevant in this connection are provided (pars 9-10).
- * The auditor should consider and evaluate management's plans to mitigate the situation (par 11).

According to ISA 570 (IFAC 1995:12-18), the auditor's reporting responsibilities are as follows:

- * If the going concern question is resolved the auditor should
 - not modify the audit report
 - consider the need for disclosure of management's plans and mitigating factors
 - qualify his opinion 'except for' or express an adverse opinion, if disclosure considered necessary is not made
- * If the going concern question is not resolved but adequate disclosure of the principal conditions that raised the doubt were made in the financial statements, the auditor should
 - not qualify his opinion nor give an adverse opinion
 - add an emphasis of a matter paragraph that highlights the going concern problem by drawing attention to the note in the financial statements disclosing the matter
- * If the going concern question is not resolved and adequate disclosure of the principal conditions that raised the doubt was not made in the financial statements, the auditor should

- provide an explanatory paragraph stating that there is substantial doubt that the entity will be able to continue as a going concern and that the financial statements do not disclose this fact
- qualify his opinion, 'except for', or express an adverse opinion
- * If the going concern concept is incorrectly used in the preparation of the financial statements and is so material and pervasive as to render it misleading, the auditor should
 - issue an adverse opinion

In June 1997, the International Auditing Practices Committee of IFAC revised ISA 570 and issued a new exposure draft on going concern (IFAC 1997a). However, the exposure draft is going to be reissued by the International Auditing Practices Committee, which is why this study does not discuss the exposure draft issued in June 1997.

3.3.2 Auditing standard issued by the American Institute of Certified Public Accountants (AICPA)

According to SAS No 59 (AICPA 1988b) an auditor has the following responsibilities:

- * An active approach is adopted because in every audit the auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time (par 2).
- * The audit of financial statements based on the assumption of liquidation is excluded (footnote 1).

- * The auditor's evaluation should cover a reasonable period of time, that is, not exceeding one year beyond the date of the financial statements being audited (par 2).
- * The auditor need not design audit procedures solely to evaluate the entity's continued existence but can rely on the results of his normal audit procedures, which are designed and performed to achieve other audit objectives. The normal audit procedures can identify conditions and events, which in the aggregate indicates substantial doubt about the entity's continued existence (par 5).
- * Examples of the normal audit procedures that can identify such conditions and events are provided (par 5).
- * A list of such conditions and events is supplied and differentiates between negative trends, other indications of possible financial difficulties, internal matters and external matters (par 6).
- * If the auditor believes that there is substantial doubt about the entity's ability to continue as a going concern, he must consider and evaluate management's plans to mitigate it (par 7).
- * Guidance is provided to the auditor on considering and evaluating such plans (pars 8-9).

According to SAS No 59 (AICPA 1988b:11-16), an auditor has the following reporting responsibilities:

- * If the substantial doubt is alleviated, the auditor should
 - consider the need for disclosure of possible effects of conditions and events, mitigating factors and management's plans
 - express an unqualified opinion

- * If the substantial doubt remains the auditor should
 - consider the possible effects on the financial statements
 - consider the adequacy of disclosures made
 - not qualify his opinion or give an adverse opinion
 - add an explanatory paragraph that follows the opinion paragraph
- * If disclosure is inadequate the auditor should
 - qualify his opinion, 'except for', or express an adverse opinion

3.3.3 Auditing standards issued by the Institute of Chartered Accountants in England and Wales (ICAEW)

The ICAEW issued their first auditing statement on the going concern assumption in 1985, Auditing Guidelines Section 3.410, *The auditor's consideration in respect of going concern* (ICAEW 1985). Section 3.410 did not meet the public's expectations. Barnes and Hooi (1987:33) wrote as follows:

A new auditing guideline is needed ... More fundamentally, the role of the auditor needs to be properly defined ... In view of changing public expectations the role of the auditor will need to go beyond mere verification to include a clear statement that the company is facing financial difficulties.

Section 3.410 (ICAEW 1985) placed a passive duty on the auditor to evaluate the entity's ability to continue as a going concern if he becomes aware of indications that the going concern assumption is questionable. In November 1994 the ICAEW issued a new Statement of Auditing Standards SAS 130, *The going concern basis in financial statements* (ICAEW 1994), which replaced Section 3.410 (ICAEW 1985) and which increases the auditor's responsibility in the evaluating of the going concern assumption.

According to SAS 130 (ICAEW 1994), the auditor's responsibilities are as follows:

- * An active approach is adopted because the auditor should assess the adequacy of the means by which the directors have satisfied themselves about
 - the going concern basis used in the financial statements
 - the required disclosures (if any) relating to going concern in the financial statements to give a true and fair view (par 21).
- * In assessing the adequacy the auditor should plan and perform audit procedures specifically designed to identify any material matters indicating going concern problems. A list of matters that the auditor's procedures need to cover is supplied, for example, budget and/or forecast information, borrowing facilities, directors' plans to resolve the going concern problem, et cetera. (Pars 21 & 23-24).
- * The procedures should cover the future period to which the directors have paid particular attention in assessing going concern. No minimum length for the future period is specified. The auditor needs to assess the reasonability of the period to which the directors paid attention (pars 13, 21 & 23).
- * Detailed guidance is provided to the auditor regarding the examination of the entity's banking/borrowing facilities (pars 25-28).
- * A list of financial, operational and other indicators of going concern problems is provided (par 31).
- * If the auditor considers that there is a significant level of concern about the entity's ability to continue as a going concern or he disagrees with the preparation of the financial statements on the going concern basis, he might decide to draw the directors' attention to the need to take suitable advice (par 32).

- * The auditor should consider the need to obtain written confirmations of representations from the directors regarding their assessment of the company being a going concern and any relevant disclosures in the financial statements (pars 33-35).

According to SAS 130 (ICAEW 1994:40-50), the auditor's reporting responsibilities are as follows:

- * If there is a significant level of concern but adequate disclosure of the matters giving rise to the concern were made in the financial statements, the auditor should
 - not qualify his opinion
 - add an explanatory paragraph
- * If there is a significant level of concern and adequate disclosure of the matters giving rise to the concern was not made in the financial statements, the auditor should
 - add an explanatory paragraph
 - qualify his opinion 'except for' or express an adverse opinion
- * If the period to which the directors have paid particular attention in assessing the going concern is less than one year from the date of approval of the financial statements and the fact is not disclosed in the financial statements or accompanying information, the auditor should
 - not qualify his opinion
 - disclose the fact within the section of his auditor's report setting out the basis of his opinion, unless the fact is clear from any other references in his report
- * If the going concern concept is incorrectly used in the preparation of the financial statements and is so material and pervasive as to make it misleading, the auditor should
 - issue an adverse opinion

3.3.4 Auditing standards issued by the Canadian Institute of Chartered Accountants (CICA)

In 1980 the CICA eliminated the 'subject to' opinion, on the basis that adequate financial statement disclosure, in accordance with GAAP, provides users with enough information without the auditor having to refer to it in his audit report.

According to the CICA Handbook Section 5510.52-53 (CICA 1989), an auditor has the following responsibilities:

- * A passive duty is placed on the auditor to evaluate the entity's ability to continue as a going concern, if during his examination, he becomes aware of conditions that cast doubt on this ability.
- * A list of the conditions which may indicate a potential problem is supplied and the auditor must assess the extent of such conditions.
- * The auditor must review and evaluate the accounting treatment, disclosure and presentation of the uncertainty to ensure that it is in accordance with generally accepted accounting principles.
- * He must ensure that the disclosure explicitly mentions the fact that the entity may be unable to continue realising its assets and discharging its liabilities in the normal course of business.

According to the CICA Handbook Section 5510 (CICA 1989), an auditor has the following reporting responsibilities:

- * If the disclosure is adequate, the auditor should
 - not qualify his opinion nor refer to it in his report (par 49)
- * If the disclosure is not in accordance with generally accepted accounting principles, the auditor should

- qualify his opinion, 'except for', or express an adverse opinion (pars 13-14)

The statement does not define the foreseeable period nor does it mention any additional audit procedures to be carried out or that management's plans should be considered or evaluated.

Boritz (1991:96) concluded that his research evidence indicated that there is a need for a change in the auditor's approach and reporting responsibility in Canada, regarding the going concern evaluation. These shortcomings have been addressed by the CICA in an exposure draft (CICA 1995). The exposure draft places an active duty on the auditor to evaluate factors that cast doubt on the entity's ability to continue as a going concern and sets out procedures which the auditor may perform to evaluate such factors. It defines a future period as one year from the date of the financial statements being audited. Any significant event that occurs outside this period should also be considered by the auditor. The exposure draft also requires the auditor to consider and evaluate management's plans to mitigate the effect of the factors that cast the doubt.

3.3.5 Auditing standards issued by the Australian Accounting Research Foundation (AARF)

In 1981 the AARF issued AUP 7, *Going Concern*, which was revised in 1986 and again in 1991. In 1995 the AARF issued AUS 708 to be compatible with the International Standard on Auditing, ISA 570 (IFAC 1995). In 1996 a revised AUS 708 was issued following the reissue of Accounting Standard AAS 6 (AARF 1995). AUS 708 (AARF 1996) contains more detailed requirements than ISA 570 (IFAC 1995).

According to AUS 708 (AARF 1996), an auditor has the following responsibilities:

- * An active approach is adopted because the auditor should obtain sufficient appropriate audit evidence that it is appropriate for management to prepare the financial statements on the going concern basis (par 10).
- * The audit of financial statements based on liquidation is excluded (par 1).
- * Guidance is provided to the auditor on how to obtain a better understanding of the entity's business and of any external and internal conditions and events which are important elements in assessing the risk of going concern problems (pars 17-18).
- * A list, which differentiates between operating, financial and other indications of going concern problems, is provided (appendix 2).
- * If the auditor considers it highly improbable that there is a going concern problem, then it is not necessary for him to design specific additional audit procedures to test for the existence of going concern problems. However, he must remain alert to the possibility that the going concern basis may be questionable when evaluating the results of other audit procedures (par 19).
- * If a going concern problem arises at any stage of the audit, the auditor should take into account that certain procedures may take on additional significance; and/or evaluate information obtained earlier; and/or employ additional audit procedures, to confirm or dispel the doubt for the relevant period (par 20).
- * Examples of audit procedures that are relevant in this connection are provided (par 21).

- * Relevant period represents the period of approximately 12 months from the date of the auditor's current report to the expected date of the auditor's report for the next annual reporting period, or in the case of interim reporting the corresponding period for the following year (par 4).
- * The auditor should consider the possibility that reasonably foreseeable circumstances may exist beyond the relevant period (pars 13-14).
- * The auditor should consider and evaluate management's plans to mitigate the situation (par 22).
- * Guidance is provided to the auditor on considering and evaluating such plans (pars 23-28).

According to AUS 708 (AARF 1996:29-33), an auditor has the following reporting responsibilities:

- * If the going concern question is resolved, the auditor should
 - express an unqualified opinion
 - consider the adequacy of the disclosure of the principal conditions that raised the doubt, management's plans and other mitigating factors
 - if disclosure considered necessary is not made, qualify his opinion 'except for' or express an adverse opinion
- * If significant uncertainty exists but adequate disclosure of the principal conditions that raise the doubt and appropriate adjustments were made in the financial statements, the auditor should
 - not qualify his opinion
 - include an emphasis of matter section in the audit report
- * If significant uncertainty exists and it is not adequately disclosed in the financial statements the auditor should

- add an explanatory paragraph
- qualify his opinion 'except for' or express an adverse opinion
- * If the auditor considers the going concern basis as inappropriate, he should
 - express an adverse opinion

3.3.6 Auditing standards issued by the South African Institute of Chartered Accountants (SAICA)

As mentioned previously (see sec 3.2.2), the Auditing Standards Committee of SAICA revised AU 294 (SAICA 1986) and issued a new exposure draft, ED 116 (SAICA 1997a), on going concern. However, the exposure draft is on hold, pending the release of a new exposure draft by the International Auditing Practices Committee (see sec 3.3.1). Hence this study does not discuss ED 116.

According to AU 294 (SAICA 1986), the auditor has the following responsibilities:

- * An active duty is placed on the auditor to consider the risk that the going concern concept is inappropriately applied, during the *planning* stage of the audit (par 7).
- * When considering this risk, the auditor should be aware of factors that may indicate doubt about an entity's ability to continue as a going concern. A list of such factors is supplied which differentiates between financial, operating and other indicators (par 8).

- * If the auditor determines that there is an unacceptable risk in the entity's ability to continue as a going concern, he should carry out further audit procedures to gather audit evidence in an attempt to reduce the audit risk to an acceptable level (par 9). No examples of such audit procedures are provided.
- * The auditor should consider information which relates to a minimum of six months following the date of the audit report or one year after the balance sheet date, whichever is the later (par 4).
- * The auditor should consider and evaluate management's plans and the bases on which they have been prepared to mitigate the situation (pars 10-11).
- * If the auditor concludes that the entity is a going concern, the statement places a further active duty on him to reconsider this conclusion during the final review and evaluation stage of the audit (par 12).
- * The auditor should discuss his findings and conclusions with the appropriate level of management before issuing his opinion (par 13).

The auditor's reporting responsibilities are discussed in the context of SAAS 700 (SAICA 1997c) because it supersedes the auditor's reporting responsibilities as outlined in AU 294 (SAICA 1986). If SAAS 700 is silent on a specific point, reference is made to AU 294. According to SAAS 700 (SAICA 1997c:30-32 & appendix II), and AU 294 (SAICA 1986:14-20), the auditor has the following reporting responsibilities:

- * SAAS 700 does not give any guidance if the going concern question is resolved. According to AU 294
 - the auditor should express an unqualified opinion
 - no disclosure of management plan's or principal conditions is required

- * If the going concern question is not resolved but adequate disclosure was made in the financial statements, the auditor should
 - not qualify his opinion
 - include an emphasis of matter paragraph in the audit report
 - decide whether it is not appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph, if the matter is so material and pervasive and fundamental
- * If the going concern question is not resolved and adequate disclosure was not made in the financial statements, the auditor should
 - add an explanatory paragraph
 - qualify his opinion 'except for'
 - express an adverse opinion, if the matter is so material and pervasive and fundamental
- * SAAS 700 does not give any guidance if the going concern is inappropriate but the financial statements applying this concept have nevertheless been prepared. AU 294 states that the auditor should consider the materiality of this disagreement and should
 - issue an unqualified opinion if the effect is immaterial
 - issue a qualified opinion 'except for' if the effect is material
 - issue an adverse opinion if the effect is fundamental
- * AU 294 states that the auditor should consider his reporting responsibility dealing with material irregularities.

3.3.7 Summary of the professional auditing standards issued

More responsibility is placed on auditors by the professional auditing standards to evaluate and report the going concern assumption. There is thus a change in emphasis from a passive to an active approach. All the auditing statements reviewed, except for CICA Handbook Section 5510 (CICA 1989), provide the auditor with guidance on evaluating an entity's ability to continue as a going concern and in expressing his audit opinion in the presence of going concern problems. The guidance and the sufficiency of the guidance provided by these statements are compared in sections 3.4 and 3.5. CICA Handbook Section 5510 (CICA 1989) is included in this comparison to a lesser extent, as it is in the process of being revised. The limited guidance provided by Section 5510 does not meet the public's expectations as this stage (see sec 3.3.4).

3.4 A COMPARISON OF THE VARIOUS AUDITING STANDARDS ON THE AUDITOR'S RESPONSIBILITY TO EVALUATE THE GOING CONCERN ASSUMPTION

A comparison of the various professional auditing standards discussed in this study, in respect of the auditor's responsibility to evaluate the going concern assumption, includes the major aspects of:

- * the approach that the statement advocates that the auditor should follow in his evaluation, that is either passive or active
- * indicators of going concern problems that the auditor should recognise and evaluate to identify if there is a going concern problem

- * the audit procedures that the auditor should perform if a going concern question arises regarding the going concern assumption
- * the impact of management's plans to overcome the entity's problems and how the auditor should evaluate it

The auditor's evaluation of the above aspects should cover a reasonable period of time. All the statements reviewed, except for CICA Handbook Section 5510 (CICA 1989) and SAS 130 (ICAEW 1994) define a reasonable period of time that ensures that auditors deal only with existing conditions and that they are not responsible for predicting future conditions or events. SAS 130 (ICAEW 1994) and AUS 708 (AARF 1996) place the responsibility on the directors to assess if the entity is a going concern for some future period, for which there is no cut off point. The auditor should assess the reasonability of this period and report on it, if it represents a period of less than one year from the date of the approval of the financial statements. A reasonable period of time has already been summarised in this study (see sec 2.3.7).

3.4.1 The approach that the auditor should follow in the evaluation of the going concern assumption

Because the auditing statements are revised, there is a greater tendency to place an *active duty* on the auditor to evaluate an entity's ability to continue as a going concern, whereas in the past it used to be a passive duty. Woolf (1983:100) defines passive/active as follows:

the passive approach: this allows auditors to *assume* financial viability unless they encounter clear indications that such an assumption is not justified, in which case a secondary series of enquiries would be triggered into action; or

the active approach: this requires auditors to pursue a specific line of inquiry invoking vigorous testing of the going concern assumption, irrespective of whether any of the indications referred to in a) [the passive approach] above manifested.

Measured against these definitions of passive/active, one may conclude that all the professional auditing standards reviewed in this study, except CICA Handbook Section 5510 (CICA 1989), require the auditor to assume an active duty in evaluating an entity's going concern status. CICA Handbook Section 5510 (CICA 1989) places a passive duty on the auditor to assume the going concern assumption, unless he becomes *aware* of conditions that may cast doubt on an entity's ability to continue as a going concern.

Although ISA 570 (IFAC 1995) and AU 294 (SAICA 1986) can be regarded as placing an active duty on the auditor in *considering* the risk that the going concern may be inappropriately applied, SAS No 59 (AICPA 1988b), SAS 130 (ICAEW 1994) and AUS 708 (AARF 1996) use more descriptive wording indicating an active action, namely, *evaluating* if there is substantial doubt and *assessing* the risk of potential going concern problems. According to AU 294 (SAICA 1986:8), the auditor still has the option not to do any evaluation if he feels that there is no risk. In considering the risk the auditor should be *aware* only of certain conditions and events which may indicate doubt about an entity's ability to continue as a going concern, whereas SAS No 59 (AICPA 1988b:3), requires the auditor to *identify* such conditions and events. AU 294 is inclined towards a passive approach and should be revised to adopt a more definite active approach. In practice, this would not involve a vast amount of incremental effort, as many audit procedures in the active approach would in any way be performed in a normal audit (Woolf 1983:100).

SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) also exclude the audit of financial statements based on liquidation, in the auditor's evaluation of going concern. The significance of this has already been pointed out in this study, namely that at a point in time before liquidation, the entity may be a nongoing concern and should be evaluated as such by the auditor (see sec 2.3.7).

3.4.2 The recognition and evaluation of indicators of going concern problems

All the auditing standards reviewed in this study provide lists of indicators to assist auditors in identifying going concern problems. The lists differentiate between financial, nonfinancial, internal and external matters. None of the standards claim that the indicators listed are exhaustive. It has been indicated in the previous chapter that some indicators are direct causes of business failure whereas others are merely symptoms of the causes (see sec 2.5.2.1).

The indicators of going concern problems listed in appendix 2 of AUS 708 (AARF 1996) are the most exhaustive compared with the other standards and include the following:

- * Operating indicators (including management attributes)
 - a lack of strategic direction including appropriately documented policies, plans and forecasts such as forward budgets and cash flow projections
 - deficiencies in the governing body, such as a lack of independent members, a low level of involvement in key decisions, poor documentation and communication of decisions, imbalance or a

- lack of expertise among members
- a lack of management expertise or loss of key management personnel
- concentration of risk in a limited number of products or projects
- a loss of a major market, franchise or licence
- prolonged industrial relations difficulties
- shortages of important supplies or the loss of a principal supplier
- deficiencies in management information systems, including blockages in information flows, or lack of management action in response to information received
- rapid or unplanned development of business (particularly in noncore activities) without commensurate developments in information systems, management expertise, financing structures, pricing policies, et cetera
- uninsured or underinsured disasters such as drought, flood, fire, fraud or sabotage

* Financial indicators

- high gearing or a net liability position
- fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- reliance on short-term borrowings to finance long-term assets
- adverse key financial ratios: working capital ratio, gross profit ratio, times interest earned, return on equity, inventory turnover, et cetera
- a lack of sustainable operating profits or cash flows from core business activities
- arrears or discontinuance of dividends
- the inability to pay creditors on due dates
- excessive reliance on transactions with related parties

- potential losses on long-term contracts or other uneconomic long-term commitments
- difficulty in complying with the terms of loan agreements or the need to restructure debt
- denial of usual trade credit from suppliers
- the inability to obtain financing for necessary new product development or other necessary investments, or conversely, overinvestment in new products, ventures or research which are not yet successful
- the need to seek new sources or methods of financing or to dispose of substantial assets

* Other indicators

- noncompliance with capital or other statutory requirements
- undue influence of a market dominant competitor
- legal proceedings against the entity that may result in judgments that could not be met or in restrictions on trading opportunities
- technical developments that render a key product obsolete
- adverse changes in legislation or government policy
- failure of other entities in the same industry
- a lack of adequate back-up and recovery capabilities for key financial or other information systems

The auditing standards stress the fact that the existence of one or more of these indicators does not necessarily signify that the going concern basis needs to be questioned [AU 294 (SAICA 1986:8); AUS 708 (AARF 1996:appendix 2); ISA 570 (IFAC 1995:6)] and that some of them may have significance only when viewed in conjunction with others [SAS No 59 (AICPA 1988b:6)]. SAS No 59 (AICPA 1988b) requires the auditor to consider these indicators in the aggregate to decide if there is substantial

doubt about the entity's ability to continue as a going concern for a reasonable period of time. AU 294 (SAICA 1986:8) states further that the absence of any such indicators may constitute audit evidence of the continuity of the entity.

The way in which practitioners in auditing practices rank these indicators of going concern problems in relative importance and the interaction between these indicators are discussed in the next chapter (see sec 4.2).

3.4.3 Audit procedures that the auditor must perform in the evaluation of the going concern assumption

SAS No 59 (AICPA 1988b) does not prescribe specific audit procedures to identify indications of going concern problems but regards the normal audit procedures as sufficient for that purpose. Boritz (1991:87) regards this as unrealistic and it has also been identified in this chapter as one of the shortcomings of SAS No 59 (see sec 3.2.1). SAS No 59 (AICPA 1988b:5) provides examples of such normal audit procedures, which may indicate substantial doubt. These are:

- * analytical procedures
- * a review of subsequent events
- * a review of compliance with the terms of debt and loan agreements
- * the reading of minutes of meetings of stockholders, board of directors and important committees of the board
- * an inquiry into an entity's legal counsel about litigation, claims and assessments
- * confirmation with related and third parties of the details of arrangements to provide or maintain financial support

According to ISA 570 (IFAC 1995) and AUS 708 (AARF 1996), if a question arises about the going concern basis, then certain audit procedures may take on additional significance and/or should be extended or modified or it may be necessary to employ additional audit procedures. ISA 570 (IFAC 1995:9-10) provide examples of procedures that are relevant in this regard, namely:

- * Analyse and discuss cash flow, profit and other relevant forecasts with management. Consider the reliability of the entity's system for generating such information and the appropriateness of the assumptions underlying the forecast.
- * Compare the prospective data for recent prior periods with historical results and the prospective data for the current period with results achieved to date.
- * Review events after the period end for items affecting the entity's ability to continue as a going concern.
- * Analyse and discuss the entity's latest available interim financial statements.
- * Review the terms of debentures and loan agreements and determine whether any have been breached.
- * Read the minutes of the meetings of shareholders, the board of directors and important committees for references to financing difficulties.
- * Address enquiries about litigation and claims to the entity's lawyer.
- * Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- * Consider the entity's position with regard to unfilled customer orders.

The examples of the audit procedures given in ISA 570 (IFAC 1995) are basically the same as the audit procedures supplied by AUS 708 (AARF 1996). SAS 130 (ICAEW 1994:25-27) provides detailed guidance to auditors on examining the existence, adequacy and terms of borrowing facilities. CICA Handbook Section 5510 (CICA 1989) does not provide the auditor with any guidance or examples of audit procedures to be performed if a going concern question arises.

AU 294 (SAICA 1986:9) requires the auditor to carry out further audit procedures if a question about the entity's continuity arises, but it does not supply any examples of such audit procedures to be performed. A South African study conducted by Gerber (1987) showed that most of the auditors in his study did not follow formal audit procedures to evaluate the going concern status of an entity. This means in effect that they rely on their normal audit procedures in the overall assessment of the entity's going concern status. The following were ranked at the top of the procedures used by the respondents in this assessment:

- * the assessment of inherent risk at the planning stage
- * the evaluation of cash forecasts and budgets
- * the use of ratio analysis to 'pick up' going concern problems, that is used as an indicator of going concern problems

ISA 570 (IFAC 1995), SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) provide examples of audit procedures that the auditor should conduct when evaluating management's plans to deal with the adverse effects of the continuity problem (see sec 3.4.4). AU 294 (SAICA 1986) should be revised to give auditors guidance on what audit procedures they should employ if a going concern question arises.

3.4.4 The evaluation of management's plans dealing with the going concern problem

In every auditing standard reviewed, except for CICA Handbook Section 5510 (CICA 1989), the auditor has a responsibility to evaluate management's plans for dealing with the adverse effects of the conditions and events that lead to the continuity problem of the entity. It has been indicated in the previous chapter that management's plans are considered rescue actions outside the normal course of operations and are warning signs of business failure (see sec 2.5.2.3). It is therefore important for the auditor to consider and evaluate these plans of management.

The extent of management's plans is divided into four main areas, namely, plans to dispose of assets (asset factors), borrow money or restructure debt (debt factors), reduce or delay expenditures (cost factors) and increase ownership equity (equity factors). ISA 570 (IFAC 1995) and AU 294 (SAICA 1986) mention these four main areas only, while SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) provide examples of each.

Appendix 3 of AUS 708 (AARF 1996) cites the following examples under each of the above-mentioned headings:

*** Asset factors**

- disposability of assets that are not operationally interdependent
- capability of delaying the replacement of assets consumed in operations or of leasing rather than purchasing certain assets
- possibility of using assets for factoring, sale and leaseback or similar arrangements

* Debt factors

- availability of unused lines of credit or similar borrowing capacity
- capability of renewing or extending the due dates of existing loans
- possibility of entering into debt restructuring agreements

* Cost factors

- separability of operations producing negative cash flows
- capability of postponing expenditures for such matters as maintenance or research and development
- possibility of reducing overhead and administrative expenditures

* Equity factors

- variability of dividend requirements
- capability of obtaining additional contributions by owners
- possibility of increasing cash distributions from subsidiaries or associates

The auditing standards require the auditor to consider and evaluate the plans of management and other mitigating factors. For example, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply. SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) provide the auditor with additional guidance in the form of basic audit procedures to evaluate these plans, compared to the other auditing standards. AU 294 (SAICA 1986) requires the auditor to consider the bases on which the plans have been prepared, that they conform with facts already known to him, that the plans are specific rather than general and that they are feasible courses of action. However, SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) elaborate on this by providing the

auditor with guidance on *how* to obtain such assurance.

Examples of audit procedures prescribed by AUS 708 (AARF 1996:22-28) to evaluate management's plans, are as follows:

- * Obtain written representations from management.
- * Analyse and discuss cash flow, profit and other relevant forecasts with management at the latest practicable date before the date of the audit report.
- * Consider the reliability of the entity's system for generating such information.
- * Consider the support for significant assumptions underlying the forecast.
- * Compare prospective data for recent prior periods with historical results, and prospective data for the current period with results achieved to date.
- * Obtain a third party's confirmation of the existence of arrangements made if their support is significant for the successful outcome of the plans.
- * Examine the existence, adequacy and terms of borrowing facilities by obtaining confirmations from bankers and making an assessment of their intentions.

ISA 570 (IFAC 1995), AUS 708 (AARF 1996) and AU 294 (SAICA 1986) all warn the auditor that the relevance of management's plans decreases as the time period for planned actions and anticipated events increases.

3.4.5 Summary of the auditor's evaluating responsibility

More responsibility is being placed on auditors to actively evaluate their clients' continued existence for a reasonable period of time. This may result in the earlier identification of going concern problems with the advantage of the auditor being in a position to make constructive suggestions and assist management to plan effective strategies to solve the problem. SAS 130 (ICAEW 1994) and AUS 708 (AARF 1996) also limit the auditor's responsibility regarding the going concern basis to assess the *adequacy of the means* by which the *directors* have to adopt or evaluate the going concern basis for a reasonable period.

Sufficient guidance is provided by the auditing standards reviewed regarding indicators of going concern problems that the auditor must recognise and evaluate. Extensive lists of examples of indications of going concern problems are provided. However, audit procedures to evaluate the indicators of going concern problems are not covered sufficiently in AU 294 (SAICA 1986) and some of the other auditing standards. The audit procedures supplied by ISA 570 (IFAC 1995) and AUS 708 (AARF 1996) give detailed guidance to auditors to evaluate identified going concern problems.

All the standards reviewed require the auditor to evaluate management's plans for dealing with the adverse effects of the conditions and events that lead to the going concern problem. However, only SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) supply the auditor with procedures on how to evaluate such plans. There is a correlation between these audit procedures and the audit procedures supplied by ISA 570 (IFAC 1995) to evaluate identified going concern problems.

None of the statements reviewed advocates the use of failure prediction models to help the auditor to evaluate an entity's continuity. However, the appendix of the Analytical Review Auditing Guideline (AUP 17) in Australia, recognises the use of failure prediction models to obtain evidence of the going concern assumption (Shailer 1988). Shailer (1988:65) regards the models referred to in AUP 17 as generally unsuitable and that the references in AUP 17 to these models should be removed.

3.5 A COMPARISON OF THE VARIOUS PROFESSIONAL AUDITING STANDARDS ON THE AUDITOR'S RESPONSIBILITY TO REPORT THE GOING CONCERN ASSUMPTION

A comparison of the requirements of the professional auditing standards regarding the auditor's reporting responsibility, indicates that it varies according to whether the going concern assumption is considered appropriate, questionable or inappropriate. In his reporting responsibility, the auditor should consider the adequacy of the disclosure of the going concern problem in the financial statements. The nature and extent of these disclosure requirements were discussed in the previous chapter (see sec 2.4).

3.5.1 If the going concern assumption is considered appropriate

If the auditor concludes that the entity will be able to continue as a going concern for the foreseeable future, he should express an unqualified opinion. This is the view of all the auditing standards reviewed.

ISA 570 (IFAC 1995), SAS No 59 (AICPA 1988b) and AUS 708 (AARF 1996) require further that the auditor should consider the need for *disclosure* of the principal conditions that raised the doubt, mitigating factors and management's plans to alleviate the going concern problem. If the necessary disclosures are not made, the auditor should express a qualified opinion, 'except for' or express an adverse opinion, on the basis of the lack of disclosure. According to AU 294 (SAICA 1986), the auditor is not required to consider any disclosures if the going concern question is resolved.

SAS 130 (ICAEW 1994) requires the auditor to consider whether the period to which the directors have paid particular attention is less than one year from the date of approval of the financial statements. If the period is less than one year it should be disclosed in the financial statements, and if it is not disclosed the auditor should mention it in the audit report. An unqualified opinion should still be issued.

3.5.2 If there is significant/substantial uncertainty about the going concern assumption

3.5.2.1 Adequate disclosure in the financial statements

ISA 570 (IFAC 1995), SAS No 59 (AICPA 1988b), SAS 130 (ICAEW 1994) and AUS 708 (AARF 1996) all require the auditor not to qualify his opinion or give an adverse opinion, but to add an explanatory/emphasis of matter paragraph in the audit report which draws attention to the note highlighting the uncertainty in the financial statements. CICA Handbook Section 5510 (CICA 1989) also requires the auditor not to qualify his opinion, but no mention of this should be made in the audit report.

AU 294 (SAICA 1986) is confusing at this stage, as it has not yet been revised. Paragraph 18 allows the auditor to issue an unqualified opinion if there is no likely impact on the carrying value of assets and liabilities and there is adequate disclosure of the going concern problem in the financial statements. Paragraph 32 of SAAS 700 (SAICA 1997c) supersedes the auditor's reporting responsibility as set out in paragraph 18. It also allows the auditor to issue an unqualified opinion but with an emphasis of matter paragraph to highlight the disclosure in the financial statements. This requirement is in line with the above-mentioned auditing standards. However, SAAS 700 (SAICA 1997c) is the only standard that allows the auditor the option to disclaim an opinion under these circumstances, if the matter is so pervasive and fundamental that according to his judgement it is not appropriate to issue an unqualified opinion.

AU 294 (SAICA 1986) should be revised to be more specific about what the auditor's reporting responsibility is if an uncertainty is adequately disclosed and when it is not adequately disclosed.

3.5.2.2 Inadequate disclosure in the financial statements

All the guidelines reviewed, except for AU 294 (SAICA 1986), which is silent on this point, require an 'except for' qualification or an adverse qualification for disagreement if an uncertainty exists and it is not adequately disclosed in the financial statements. An explanatory paragraph, stating that there is substantial doubt about the entity's ability to continue as a going concern and that the financial statements do not disclose this fact, forms part of the audit report. However, these requirements do form part of SAAS 700 (SAICA 1997c) that supersedes AU 294 (SAICA 1986).

3.5.3 If the going concern assumption is considered inappropriate

ISA 570 (IFAC 1995), SAS 130 (ICAEW 1994) and AUS 708 (AARF 1996) require the auditor to issue an adverse opinion if he comes to the conclusion that the going concern assumption is being inappropriately used in the preparation of the financial statements. SAS No 59 (AICPA 1988b) and CICA Handbook Section 5510 (CICA 1989) are silent on this point.

In considering the materiality of the effect of this disagreement, AU 294 (SAICA 1986:16) gives the auditor the option to issue an unqualified, qualified or adverse opinion, as appropriate. SAAS 700 (SAICA 1997c) is silent on this point. In the light of the seriousness of this situation where it is completely predictable that a company will be forced to cease operations but the financial statements have nevertheless been prepared on a going concern basis, one cannot possibly see how the auditor can issue an audit report without saying a word about the problem or even qualifying 'except for'. An adverse opinion seems to be appropriate under these circumstances because of the pervasive effect of using the assumption.

3.5.4 Summary of the auditor's reporting responsibility

The auditor's reporting responsibility, according to the professional auditing statements, are summarised in table 3-2. The reporting requirements of ISA 570 (IFAC 1995), SAS No 59 (AICPA 1988b), SAS 130 (ICAEW 1994) and AUS 708 (AARF 1996) are all quite in line.

TABLE 3-2
COMPARISON OF THE GOING CONCERN STANDARDS -
THE AUDITOR'S REPORTING RESPONSIBILITY⁷

Standard	Going concern resolved	Going concern uncertainty		Going concern Invalid
		Adequate disclosure	Inadequate disclosure	
ISA 570	Unqualified + consider disclosure IF nondisclosure, 'except for'	Unqualified + emphasis of matter paragraph	'Except for' or adverse opinion	Adverse opinion
SAS No 59	Unqualified + consider disclosure IF nondisclosure, 'except for'	Unqualified + explanatory paragraph	'Except for' or adverse opinion	Silent
SAS 130	Unqualified + consider period paid attention to by directors	Unqualified + explanatory paragraph	'Except for' or adverse opinion	Adverse Opinion
AUS 708	Unqualified + consider disclosure IF nondisclosure, 'except for'	Unqualified + emphasis of matter paragraph	'Except for' or adverse opinion	Adverse opinion
AU 294/ SAAS 700	Unqualified opinion	Unqualified + emphasis of matter paragraph OR disclaimer of opinion if pervasive + fundamental	'Except for' or adverse opinion	Unqualified or 'except for' or adverse opinion

⁷ If a qualification is issued all these standards require a paragraph explaining the qualification to precede the opinion paragraph.

The reporting requirements of AU 294 (SAICA 1986) differ from the other standards reviewed and need to be revised to be in line with SAAS 700 (SAICA 1997c) and to be more specific when there is/is not adequate disclosure of the going concern problem in the financial statements. The option to issue an unqualified opinion under AU 294 (SAICA 1986), when there is uncertainty about the going concern assumption or when the going concern assumption is considered to be inappropriate, should also be reconsidered for revision.

The degree of assurance that is required to confirm/dispel uncertainty about the going concern assumption is not spelled out in the auditing standards on going concern. The standards require the auditor to consider if 'substantial doubt' or 'significant uncertainty' about the entity's ability to continue as a going concern remains or is dispelled but without defining these terms.

The 'subject to' qualification for uncertainties has been eliminated in all the auditing standards reviewed. However, a 'red flag' to warn users of financial statements about the entity experiencing going concern problems has been retained in the form of an explanatory paragraph.

3.6 CONCLUSION

This chapter has examined the guidance provided by the existing professional auditing standards to the auditor in evaluating and reporting on the going concern assumption. The auditing standards issued by the International Federation of Accountants, the United States, the United Kingdom, Canada and Australia were compared with the South African

standard with a view to critically analysing the South African standard. It may be concluded that current standards in the United States, the United Kingdom and Australia are providing sufficient guidance to auditors, although there are still some shortcomings.

This chapter has indicated that the evolution of the going concern assumption, in all the professional auditing standards reviewed, has advanced to a stage where the auditor is required to follow an active approach in the evaluation of the going concern assumption. The auditing standard of Canada is in the process of being revised to adopt a more active approach. The South African standard needs to be revised to adopt a more definite active approach.

Shortcomings identified in the auditing standards are the absence of specific audit procedures, to evaluate the going concern assumption and to evaluate management's plans to deal with the adverse effects of the going concern problem, and the fact that substantial/significant doubt is not well defined. The South African standard needs to be revised to address these shortcomings. An examination of the auditor's reporting responsibility in the presence of a going concern problem has revealed that the South African standard, AU 294 (SAICA 1986), differs from the other standards reviewed and that it needs to be revised to be compatible with the international requirements.

The next chapter examines empirical research studies that have been conducted on the auditor's decision making in the presence of going concern uncertainties.



CHAPTER 4

AUDITOR'S DECISION-MAKING IN THE PRESENCE OF GOING CONCERN UNCERTAINTIES

4.1 INTRODUCTION

The previous chapters have examined the guidance provided by the professional accounting and auditing standards to the auditor in evaluating the going concern assumption. It has been indicated that the professional auditing standards provide general guidelines on how auditors should evaluate the going concern assumption. According to these standards auditors first have to evaluate various types of evidence (indicators of going concern problems) to determine the nature and significance of any of the client's financial problems. Secondly, for all significant problems, the auditor should consider and evaluate any mitigating factors, such as management plans to overcome the problems as well as any aggravating factors. Only then will the auditor be in a position to reach a decision whether or not a going concern qualification should be issued.¹

¹ Any referral to a going concern qualification in this chapter is meant to be a qualification as set out in section 3.5.

The objective of this chapter is to review empirical work conducted on the auditor's decision-making process in the presence of going concern uncertainties, to establish if the auditor's decision-making process does follow the guidelines as set out in the professional auditing standards. In reviewing these empirical research studies on the auditor's decision-making process another objective of this chapter is to:

- * determine which indicators are used or are considered important by auditors to identify companies as going concern problem companies
- * identify factors that influence the auditor's decision to issue a going concern qualification
- * report on the auditor's failure to issue a going concern qualification by analysing the frequency of the misclassification of a nongoing concern as a going concern (Type I error) and analysing the frequency of the misclassification of a going concern as a nongoing concern (Type II error)
- * report on the status of going concern qualifications issued in the Republic of South Africa
- * determine whether the issuance of the South African auditing standard, AU 294 (SAICA 1986), had any affect on the auditor's qualifying behaviour
- * determine whether the consequences of qualifying influence the auditor's decision to issue a going concern qualification

4.2 THE AUDITOR'S IDENTIFICATION OF A GOING CONCERN PROBLEM COMPANY

The results of a study conducted by Kida (1980:186) revealed that the auditor's identification of a going concern problem company is separate from his decision to issue a going concern opinion. The identification of characteristics that mark a company as a potential recipient of a going concern opinion represents the first stage in the auditor's going concern decision-making process. Such a company is called a going concern problem company and the characteristics are indicators of going concern problems.

Numerous warning signs/indicators of financial problems or of impending business failure have been identified in the literature, which distinguishes between operating and financial indicators and which has cited poor management as the initial cause of business failure (see sec 2.5.2.1). All the professional auditing standards reviewed, provided lists of indicators of going concern problems which can help auditors to identify companies with going concern problems. The lists distinguished between financial, nonfinancial, internal and external indicators (see sec 3.4.2).

This section examines various behavioural research studies that have employed audit managers and partners as subjects to determine which indicators are used by them or considered important by them to identify companies as having going concern problems.

4.2.1 Ranking of indicators of going concern problems

4.2.1.1 *Ranking of financial evidence indicators*

The author was able to locate four behavioural research studies that examine which of the indicators supplied in the professional auditing standards are regarded as valuable going concern problem company indicators by auditors and if there are any other indicators not supplied in the auditing standards that they regard as important. These research studies are summarised in table 4-1. The results of the Kida (1980) and the Mutchler (1984) studies were obtained from questionnaire responses received, that elicited from audit partners specific indicators used by them to identify going concern problem companies. Williams (1990) and Gerber (1987) supplied auditors with indicators listed in SAS No 59 (AICPA 1988b) and AU 294 (SAICA 1986) respectively, which the auditors had to rank according to relative importance.

Audit partners in the Mutchler (1984:25) study indicated that the two criteria, 'enter receivership'² and 'enter reorganisation proceedings' are sufficient in themselves to indicate the presence of going concern problems. They were also ranked (a) and (b) indicators in the Kida (1980:509) study. When the stages of business failure were discussed in chapter 2 of this study, these two criteria were also identified as indicators of very substantial doubt about the validity of the going concern assumption (see sec 2.5). Williams (1990) and Gerber (1987) did not supply the partners in their studies with these two criteria because they are not included in SAS No 59 (AICPA 1988b) and AU 294 (SAICA 1986). In fact they were not included in any of the professional standards reviewed,

² 'Enter receivership' was defined earlier in this study (see table 2-2).

TABLE 4-1
BEHAVIOURAL RESEARCH STUDIES -
INDICATORS OF GOING CONCERN PROBLEMS RANKED BY AUDITORS

Kida (1980)	Mutchler (1984)	Gerber (1987)	Williams (1990)
Enter receivership	Enter receivership	Substantial borrowing without prospects of renewal or repayment	Default on loan payment/similar agreement
Enter reorganisation	Enter reorganisation	Net liability position	Recurring operating losses
Unable to meet interest payments	Unable to meet interest payments	Net current liability position	Denial of usual trade credit from suppliers
Three straight years of losses	Three straight years of losses	Loss of major market, franchise or licence	Negative cash flow from operations
Liquidate its assets	Three straight years of deficit	Substantial losses	Arrearages in dividends
Three straight years of deficit	Negative net worth	Pending legal proceedings	

although they appear to be highly ranked as going concern problem indicators by practising auditors.

Of all the indicators of going concern problems supplied by the professional standards, an entity's inability to meet interest payments/loan payments or to repay or renew borrowings approaching maturity, are regarded by the auditors in the above-mentioned studies as the most important indicator of going concern problems. This is confirmed by a study conducted by Chen and Church (1992:30) which revealed that auditors rely heavily on the default status of an entity in making going concern decisions. The default status is an entity that has difficulty fulfilling its debt obligations, such as compliance with lending agreements or making scheduled payments and the restructuring of debt³ and management's negotiations with creditors to cure the default of agreements or to reschedule payments.

The auditors in the studies listed in table 4-1 have also identified recurring losses, which appear in the lists of indicators supplied by the professional standards, as an important indicator of going concern problems.

Mutchler (1986) conducted another study in which she identified a group of 119 going concern problem companies that had not received a going concern qualification. None of these companies has met one of the three most important indicators of going concern problems identified in the above-mentioned empirical research studies, namely receivership, reorganisation and inability to meet interest payments. The absence

³ Restructuring of debt is listed by the professional standards as an indicator of going concern problems as well as a plan of management to mitigate the adverse effects of the going concern problem. Chen and Church's study also confirms that restructuring of debt is an indicator of going concern problems as well as a factor that influences the auditor's decision to issue a going concern qualification (see sec 4.3.2).

thereof confirms the importance of these three criteria to auditors as indicators of going concern problems. It also points to the fact stressed in AU 294 (SAICA 1986) that the absence of any one of the going concern problem indicators may constitute audit evidence of the continuity of the entity (see sec 3.4.2).

Williams (1990) supplied the auditors in his study with only five of the indicators listed in SAS No 59 (AICPA 1988b) whereas Gerber (1987) supplied the auditors with 16 of the indicators listed in AU 294 (SAICA 1986). Arrearages in dividends were listed overall number 16 in Gerber's study and five in Williams's study and thus appear to be of little or no importance to auditors as an indicator of going concern problems.

4.2.1.2 Ranking of adverse key financial ratios

The professional standards list adverse key financial ratios as an indicator of going concern problems. In the Gerber study (1987:49), 77 percent of the auditors indicated that they use financial ratio analysis to 'pick up going concern problems'. In another study, auditors were supplied with only financial ratio data and were able to discriminate between going concern problem companies and nongoing concern problem companies with an average accuracy rate of 83 percent (Kida 1980:520). These results suggest that financial ratio data may provide useful information for auditors when identifying companies with going concern problems.

This section examines which financial ratios auditors consider to be more important than others.

Auditors in the Mutchler study (1984:28) indicated that debt-related ratios were crucial from their point of view. Five of the top six ratios rated by them were debt-related ratios. The top six ratios rated by these auditors in order of preference are as follows:

- (1) cash flow/total debt
- (2) current assets/current liabilities
- (3) net worth/total debt
- (4) total debt/total assets
- (5) total liabilities/total assets
- (6) net income/net sales

The auditors in the Gerber study (1987) also showed preference for debt-related ratios. Four of the top six ratios rated by them were debt-related ratios. Gerber gave insufficiently clear instructions to the auditor subjects in the ranking of the ratios, which resulted in two sets of data. Gerber did a Spearman Rank Correlation Coefficient test and concluded that: '...one may safely draw the same conclusion from both sets of data' (Gerber 1987:58). The top six ratios rated in the one set of data were also under the top six ratios in the other set but not exactly in the same order. The top six ratios identified by these two sets of data are as follows:

- (1) quick assets/current liabilities⁴
- (2) cash flow/total liabilities
- (3) cash flow/total debt
- (4) return on total assets
- (5) total debt/total assets
- (6) net income/net sales

⁴ Mutchler did not supply the auditor subjects in her study with the quick assets/current liabilities ratio, although the subjects did mention it most frequently in the interviews.

Levitan and Knoblett (1985:38) identified the ratio of total debt/total assets as the most heavily weighted variable used by auditors in their study.

Auditors in a study by Simnett and Trotman (1989) identified the following ratios that they preferred, in order to distinguish between failed and nonfailed firms:

- * cash flow before tax/financial debt
- * current ratio
- * quick asset ratio

In summary, the following five ratios have been identified in more than one of the above-mentioned studies as being crucial to auditors as indicators of going concern problems, namely:

- (1) current assets/current liabilities (current ratio)
- (2) quick assets/current liabilities (quick asset ratio)
- (3) cash flow/total debt
- (4) total debt/total assets
- (5) net income/net sales

Two ratios that were indicated as being considered the least important by the auditors in the studies of Mutchler (1984) and Gerber (1987) were net sales/total assets and net income/total assets or retained earnings/total assets.

4.2.1.3 Ranking of nonfinancial evidence indicators

All of the studies mentioned in table 4-1 focused primarily on the ranking of financial evidence indicators. Nonfinancial indicators of going concern problems can be related to the indicators of business failure identified in chapter 2 and specifically to poor management which has been identified as the initial cause of business failure (see sec 2.5.2.1).

Ponemon and Schick (1991) conducted a study employing 86 audit managers to determine their perceptions of 12 organisational decline characteristics for 43 financially distressed firms and 43 nondistressed firms. The study provided evidence that auditors associated six of the 12 characteristics of organisational decline with clients in financial distress. The six characteristics are as follows:

- (1) Long-term planning is neglected.
- (2) Key managers and administrators are often scapegoats.
- (3) There is a great deal of turnover in management and administrative positions.
- (4) Morale is declining within the organisation.
- (5) There is no place where the organisation can cut expenditures without severely damaging itself.
- (6) When cutbacks do occur they are not prioritised.

These characteristics of organisational decline are indicators of going concern problems but management can still implement plans to deal with the adverse effects thereof. The combination of these qualitative characteristics of organisational decline together with the financial evidence indicators can provide the auditor with a good perception of whether or not the company is a going concern problem company.

4.2.2 Interaction of going concern problem indicators

In contrast to the overall conclusion drawn in the ranking of the financial evidence indicators that arrearages in dividends are of little or no importance, it was found that six of the respondents in Gerber's study (1987:51) regarded it as very important and one respondent even as sufficient alone to indicate going concern problems. This inconsistency indicates that auditors do not view indicators of going concern problems in isolation. In another study (Williams 1984:14), there was also little consistency in the rankings of going concern problem indicators by audit partners. This suggests that no one indicator dominates the going concern judgment, but that the *interaction of the indicators* was considered to be of vital importance. It confirms the fact emphasised in the professional standards reviewed, that some indicators may have significance only when viewed in conjunction with other indicators (see sec 3.4.2).

Mutchler (1986) identified a set of 15 problem company criteria that were obtained from previous research, interviews, questionnaires and examination of data from a set of companies that had received a going concern qualification (see table 4-2). The criteria are all solvency-related and are highly correlated; for example, a company entered in reorganisation proceedings will probably also have losses, deficits and negative working capital. A group of 119 going concern problem companies with going concern qualifications and a group of 119 going concern problem companies without going concern qualifications⁵ were examined to determine the total number of problem criteria met by a company.

⁵ Going concern problem companies without going concern qualifications were companies that met at least one of the going concern problem criteria.

The results showed that a company that meets eight or more of the problem criteria listed in table 4-2 is more likely to receive a going concern qualification and that a company with five or less of the criteria is likely to receive an unqualified opinion (Mutchler 1986:156). Thus the higher the total number of problem criteria met by a company, the greater the likelihood is that the company will receive a going concern qualification. This confirms the professional standards that the auditor considers the going concern problem indicators *in the aggregate* to decide whether or not there is substantial doubt about the going concern assumption (see sec 3.4.2). This was also confirmed by one of the auditor subjects in the Gerber study (1987:60) who stated that he found it extremely difficult to rank the financial ratios in order of importance because their overall impact was weighed up before any conclusions were drawn.

When a company exhibited six or seven of the problem criteria it was just as likely to receive an unqualified opinion as it was to receive a qualified opinion (Mutchler 1986:158). This suggests that other factors must have influenced the auditor's decision to issue or not to issue a going concern qualification (see sec 4.3).

4.2.3 Summary of the auditor's identification of a going concern problem company

The professional auditing standards provide the auditor with lists of indicators of going concern problems. The results of behavioural research studies have indicated that some of these indicators are regarded as more important than others by auditors to identify a going concern problem company.

TABLE 4-2
GOING CONCERN PROBLEM COMPANY CRITERIA

- (1) Enter receivership
- (2) Enter reorganisation
- (3) Inability to meet interest payment
- (4) Going concern audit report in previous year
- (5) In liquidation
- (6) Negative net worth
- (7) Negative cash flow
- (8) Negative working capital
- (9) Three straight years of losses
- (10) Three straight years of deficit
- (11) Two straight years of losses
- (12) Two straight years of deficit
- (13) Current year loss
- (14) Current year deficit
- (15) Negative income from operations

Source: Mutchler (1986:151)

The default status of a client which involves the client's inability to meet interest/loan payments or to repay/renew borrowings approaching maturity was identified as the most important indicator of going concern problems. Recurring losses were also identified as an important indicator of going concern problems. However, two financial evidence indicators that were highly ranked by the auditors as indicators of going concern problems, namely 'enter receivership' and 'enter reorganisation proceedings', do not appear in the auditing standards. The auditing standards should be amended to include these two criteria in the lists of indicators of going concern problems.

It has also been indicated that auditors use financial ratio analysis to 'pick up going concern problems'. Debt-related ratios were identified by the auditors as the most important ratios to indicate going concern problems, as well as the ratio of net income/net sales.

The combination of nonfinancial and financial indicators of going concern problems may provide the auditor with a good perception of the company being a going concern problem company or not. This section indicated that auditors consider going concern problem indicators in the aggregate as well as the interaction between these indicators in identifying a company as a going concern problem company.

However, the identification of a going concern problem company does not necessarily lead to a going concern qualification as management can still implement plans to deal with the adverse effects of the going concern problems. The auditor should take these plans into account and evaluate them before a going concern decision can be made (see sec 4.3).

4.3 FACTORS THAT INFLUENCE THE AUDITOR'S DECISION TO ISSUE A GOING CONCERN QUALIFICATION

The second stage in the auditor's decision-making process is the consideration and evaluation of factors that may influence the auditor's decision to issue a going concern qualification.

The factors to be considered and evaluated by the auditor include management's plans to mitigate the going concern problem as well as any other factors that may aggravate the going concern problem. The professional auditing standards reviewed divide management's plans into plans to dispose of assets, plans to borrow money or restructure debt, plans to reduce or delay expenditures and plans to increase ownership equity (see sec 3.4.4).

Mitigating and aggravating factors can be classified as prospective information factors. The section below examines empirical studies that have assessed the influence of historical information factors and prospective information factors on the auditor's going concern decision.

4.3.1 The influence of historical information factors on the auditor's decision to issue a going concern qualification

It was indicated in the previous section that historical information, such as recurring losses and financial ratio analysis, may provide important indications of going concern problems (see sec 4.2.1). However, as indicated in this section this information may not influence the auditor's decision to issue a going concern qualification, as it is not the final factor to be considered by the auditor in the decision-making process.

Mutchler (1986) used discriminant scores generated by a financial ratio model (historical information) to assess the relative degree of financial distress exhibited by companies that did receive a going concern qualification and those that did not. The companies were divided into three groups, namely those meeting five or fewer of the problem criteria, those meeting six or seven and those meeting eight or more of the problem criteria (see sec 4.2.2 for a more detailed description of this specific study). For the group of companies falling into the six or seven problem company criteria category, it was found that the companies that *did not* receive a going concern qualification, exhibited a *higher* degree of financial distress in contrast to those that did receive a going concern qualification. The group of companies falling into the eight or more problem company criteria category showed essentially the *same level* of financial distress whether they were qualified or not. These findings are in contrast to normal expectations and indicate that there must be factors other than or in addition to financial distress exhibited by the companies (based on historical information) that led to the auditor's opinion decision. This confirms that historical information is not a determining factor in an auditor's decision to qualify or not to qualify.

Auditors have indicated that they seldom use financial ratio analysis⁶ in their decision to issue a going concern qualification because they have an insider's view of management (intimate knowledge of the client) and do not have to resort to ratio analysis (Gerber 1987:43, Mutchler 1984:27). Financial ratios also become less reliable as failure approaches because of the effect of creative accounting (see sec 2.5.2.1). These can be interpreted as reasons why some auditors do not use financial ratio analysis in their going concern decision.

⁶ Financial ratio analysis is performed on historical information as reflected in the financial statements.

Levitan and Knoblett (1985:39) refer to an observation made by the Cohen Commission on financial ratios, namely:

The Cohen Commission was mindful of research showing that analysis of financial statements using certain simple ratios was a better indicator of a company's future prospects than noting whether the auditor had expressed a qualified opinion or an unqualified opinion. This study provides some confirmation of this observation.

The Cohen Commission's observation and the study of Levitan and Knoblett could in effect mean that auditors do not use financial ratio analysis in their final decision to issue a going concern qualification or not.

Historical information is thus not a determining factor in the auditor's going concern opinion. However, it is an indicator of going concern problems and is used by auditors as such to identify going concern problem companies.

4.3.2 The influence of prospective information factors on the auditor's decision to issue a going concern qualification

Prospective information factors can be divided into the following two groups:

- (1) mitigating factors that will prevent a going concern qualification
- (2) aggravating factors that will determine a going concern qualification.

Mitigating factors can be related to management's plans for dealing with the adverse effects of the conditions and events that lead to the entity's continuity problems. Aggravating factors are factors that can aggravate the identified going concern problem. Mitigating and aggravating factors may be either solvency-related or nonsolvency-related items.

Management's plans to mitigate the adverse effects of going concern problems are divided by the auditing standards reviewed, into plans to dispose of assets, borrow money or restructure debt, reduce or delay expenditures and increase ownership equity (see sec 3.4.4). Nine out of 15 audit partners interviewed by Williams (1984:16) indicated that management's plans to borrow money or restructure debt and plans to reduce or delay expenditures were considered more important than plans to dispose of assets or to increase ownership equity because those benefits are realised most quickly.

Restructuring of debt has been indicated as a vital indicator of going concern problems (see sec 4.2.1.1). However, it is also one of management's plans to mitigate the entity's going concern problems and is considered by the auditor to be a very important factor in his decision to issue or not to issue a going concern qualification. This is confirmed by the results of Chen and Church's (1992:31) study which indicated that 77 percent of a group of 127 firms that received a going concern qualification were in default or in the process of restructuring their debt. A control group of 127 going concern problem firms that did not receive a going concern qualification was also examined. Only one firm in the control group was in default. These results suggest that if an entity is in default or in the process of restructuring its debt, this creates *substantial doubt* in the auditor whether the entity is a going concern and influences his going concern decision.

Mutchler (1986) used good news (mitigating factors) and bad news (aggravating factors) items as variables to determine the impact on the auditor's qualifying behaviour (see table 4-3). For the group of companies falling into the categories of meeting six or seven and eight or more of the problem company criteria, it was found that the companies that did not receive a going concern qualification had, on average, a greater number of good news items and a smaller number of bad news items, and vice versa for the companies that did receive a qualification. The results of Mutchler's study indicate that auditors do take into account mitigating and aggravating factors in their decision to issue or not to issue a going concern qualification.

A study by Arnold and Edwards (1993:61) also confirms that the auditor's decision to issue a going concern qualification is influenced by prospective information:

The results of this study, for example, suggest a significant loss from operations in the current year may be a significant factor used by auditors to identify potential going concern problems. However, because of its historical rather than prospective nature, the current year's loss may not be important in the actual decision whether an explanatory paragraph on continuity is needed. The going concern decision tends to be based on prospective information- credit, economic outlook, litigation, etc., not on factors related to past performance.

TABLE 4-3
GOOD NEWS AND BAD NEWS VARIABLES

Bad news	Good news
<p>Default on debt</p> <p>Inventory obsolescence</p> <p>Loss of major customer</p> <p>Accounts receivable factoring</p> <p>Preferred dividend arrearages</p> <p>Employee strike</p> <p>Federal tax lien</p> <p>Product obsolescence</p> <p>Lost money on a fixed-price contract</p> <p>Loss of purchase discounts from suppliers</p> <p>In reorganisation</p>	<p>Line of credit available</p> <p>Successful new product</p> <p>Increase in research and development expenditures</p> <p>Sale of common stock</p> <p>Issue of new debt</p> <p>Forgiveness of debt including preferred dividends</p> <p>Restructuring of debt</p> <p>Waivers obtained for violation of debt covenants</p> <p>Obtained employee and supplier concessions</p>
<p>Source: Mutchler (1986:154)</p>	

4.3.3 Summary of the factors that influence the auditor's decision to issue a going concern qualification

This section indicates that historical information, as reflected in the financial statements, is not a determining factor that influences the auditor's decision to issue or not to issue a going concern qualification. Auditors have also indicated that they do not have to resort to ratio analysis (historical information) to make a going concern decision because they have *intimate knowledge of the client* which allows for judgments to be made about management performance and management restructuring (prospective information).

The auditor's decision to issue or not to issue a going concern qualification is influenced by prospective information factors. Prospective information factors consist of management's plans to mitigate the going concern problem situation as well as any other factors that may aggravate the situation. Certain plans of management, as identified by the professional auditing standards, are considered to be more important than others by auditors in public practice. Management's plans to restructure debt have been indicated as a vital factor that influences the auditor's decision to issue or not to issue a going concern qualification.

After evaluating the mitigating and aggravating factors, the auditor is in a position to qualify or not to qualify the going concern problem company's financial statements. However, many companies have failed without receiving a going concern qualification in their audit report for the last financial statements issued prior to the bankruptcy. The degree to which auditors fail to issue going concern qualifications when needed is discussed in the next section.

4.4 THE AUDITOR'S FAILURE TO ISSUE THE APPROPRIATE GOING CONCERN QUALIFICATION

As statistics indicate in this section, paradoxically, the majority of companies that have failed did not receive a going concern qualification prior to failure, while companies that did receive a going concern qualification actually survived. This section explores this phenomenon.

4.4.1 The misclassification of a nongoing concern as a going concern (Type I error)

The results of a number of empirical research studies performed in the United Kingdom and the United States have shown that less than 50 percent of bankrupt companies received a going concern qualification for the last financial statements issued prior to the bankruptcy (see table 4-4).

From these statistics it would seem that auditors are not very good at warning about impending failure within the foreseeable future.

According to the auditing standards, the auditor has a responsibility to evaluate whether the entity will be able to continue in operational existence for the *foreseeable future*. If the auditor issues an audit report without a going concern qualification this in effect means that the entity will continue in operational existence for the foreseeable future.⁷

⁷ Foreseeable future has already been defined in this study (see sec 2.3.7).

TABLE 4-4
FAILED COMPANIES WITH GOING CONCERN QUALIFICATIONS

Study	No of failed companies	% qualified on going concern issues
Altman & McGough (1974:53) USA	28	46%
Taffler & Tseung (1984:263) UK	86	24%
Menon & Schwartz (1986:46) USA	147	43%
Barnes & Hooi (1987:32) UK	42	33%
Peel (1989:333) UK	40	27,5%
Citron & Taffler (1992:339) UK	107	26,2%

However, the results of two studies performed in the United Kingdom (Citron & Taffler 1992:341; Taffler & Tseung 1984:264) indicated that only 40 percent of the companies that failed within the scope of the definition of foreseeable future did receive a going concern qualification. For the remaining failed companies, the audit report did not draw attention to the fact that the company might not continue in operational existence in the foreseeable future.

The situation in which a liquidation or reorganisation (bankruptcy) occurs and the auditor does not issue a going concern qualification is generally known in the literature as a Type I error (Altman 1982:14; Hopwood, McKeown & Mutchler 1989:36). For example, if 26,2 percent of the 107 failed companies in Citron and Taffler's study (see table 4-4) received a going concern qualification, then a 73,8 percent Type I error occurred.

The consequences (costs) of Type I errors can be described as follows (Altman 1982:15; Bourne 1986:475; Kida 1980:521):

- * There is negative publicity for the profession and the audit firm.
- * The auditor's integrity and independence are challenged.
- * Scarce economic resources are misallocated.
- * The decisions of entrepreneurs, creditors, investors and others are affected.
- * There are lawsuits against the auditor by the client's creditors and investors.
- * Management may not be as aware of the seriousness of the situation as when a qualification has been given.

A Type I error is considered to be more detrimental than a Type II error, which is the misclassification of a going concern as a nongoing concern, for two reasons, namely (Koh 1992:188; Levitan & Knoblett 1985:32; Williams 1984:18):

- (1) The possible financial consequences to the auditing firm are much greater.
- (2) This is the error most often made in practice.

4.4.2 The misclassification of a going concern as a nongoing concern (Type II error)

A Type II error occurs when a company is issued with a going concern qualification, that is classified as a nongoing concern, but does not subsequently fail (Altman 1982:17; Hopwood et al 1989:36).

The results of a number of empirical research studies indicate that the majority of companies qualified on a going concern basis actually survived (see table 4-5). Peel and Peel (1987:65) state that it is difficult to find a rationale for why this should be the case:

It would appear that further research is required to establish the exact grounds upon which the going concern qualification is given for a particular firm. A referee is somewhat less surprised by the result. He points out that to provide a going concern qualification for a company which is really on the rocks is to make, in effect, the momentous decision to push it over the edge. On the other hand if a company is really fairly sound but in a technically insolvent position then the auditor is not in such a difficult position. Clearly there is a need for more work on this issue.

TABLE 4-5
SUBSEQUENT STATUS OF COMPANIES WITH
GOING CONCERN QUALIFICATIONS

Study	No of companies with going concern qualifications	% of companies that did not subsequently fail
Altman (1982:16)	213	75%
Barnes and Hooi (1987:32)	51	94,1%
Taffler and Tseung (1984:267)	40	70%
Citron and Taffler (1992:343)	86	71%

The consequences (costs) of Type II errors can be described as follows (Altman 1982:17; Kida 1980:521):

- * negative impact on the accounting firm's reputation
- * potential loss of a client
- * deteriorated relations with the client
- * lawsuit by the client against the auditor
- * cause client to have going concern problems

Altman (1982:17) reported that Type II errors seem to occur more frequently than Type I errors. This is in direct contrast with the results reported by a number of other empirical studies (Koh 1992:188; Levitan & Knoblett 1985:32; Williams 1984:18) (see sec 4.4.1).

4.4.3 Comparison between failed companies with a going concern qualification and failed companies without a going concern qualification

This section indicates that failed companies that receive going concern qualifications are more acutely financially distressed and fail in shorter periods after the publication of their accounts, than failed companies that did not receive going concern qualifications.

Citron and Taffler (1992:338) tested the hypothesis that the weaker the financial position of the failing company is at the balance sheet date, the more likely it is to have received a going concern qualification. The results of their study (Citron & Taffler 1992:341) as well as the results of other empirical studies (Menon & Schwartz 1986:47; Peel 1989:344) suggest that unless the likelihood of failure is very high, the probability of

a going concern qualification is very low. These results offer evidence to the effect that auditors do not issue qualifications arbitrarily and that failing companies that received going concern qualifications, in their last accounts before failure, were more acutely financially distressed than failing ones that were not qualified on that basis.

Citron and Taffler (1992:340) and Taffler and Tseung (1984:263) examined the failed companies that received going concern qualifications and found one of two situations to be present:

- (1) The weak financial status of the company was public knowledge prior to the issuance of the going concern qualification.
- (2) The company's financial situation was so critical that the auditor would have been negligent to an exceptional degree if he had not issued a going concern qualification.

These situations were found to be valid for 71 percent of the companies in Citron and Taffler's study and 80 percent of the companies in Taffler and Tseung's study. Menon and Schwartz (1986:47) issued the following warning on this issue as well:

One clear implication of our findings for bankers is that limited reliance should be placed on the auditor's report as a warning device for spotting companies about to fail. Auditors seem more ready or able to blow the whistle on a company when its financial ratios have deteriorated to where a default either has already happened or is probable in the immediate future.

However, given these above-mentioned results it is not obvious why the majority of firms with going concern qualifications actually survive as reported in section 4.4.2. Peel (1989:344) hypothesises that those companies either received an incorrect qualification or are correctly qualified on the basis of the information available to the auditor at that time, but subsequently recover and/or are kept afloat for a longer period by factors outside the auditor's scope of vision.

Citron and Taffler (1992:338) also tested the hypothesis that the shorter the time between publication of accounts/audit report signature and failure, the greater the propensity is for qualification. The results of three other studies performed in the United Kingdom support this hypothesis (see table 4-6). The average time lag between publication of accounts and failure for companies with going concern qualifications represented a shorter period in each one of the studies compared to the average time lag for companies without going concern qualifications.

4.4.4 Empirical survey of South African auditors' failure to issue failed companies with a going concern qualification

Because of a lack of empirical research studies conducted in the Republic of South Africa on the auditor's going concern qualification, the audit reports of 20 industrial companies whose listings were terminated on the Johannesburg Stock Exchange because of financial failure between 1981 and 1991, were examined. The results of the survey are set out in appendix A, table A-1.

TABLE 4-6
TIME LAG BETWEEN PUBLICATION OF LAST ACCOUNTS/
AUDIT REPORT DATE AND FAILURE

Study	Time lag in months: companies with going concern qualifications	Time lag in months: companies without going concern qualifications
Taffler & Tseung (1984:264)	4	9
Peel (1989:343)	6,71	10,62
Citron & Taffler (1992:341)	5,5	8,7

The last available audited annual financial statements⁸ that could be located for the 20 companies before failure were examined to determine the nature of the auditors' opinions issued in the auditors' reports. The auditors' opinions indicated going concern problems in only 25 percent (five of the 20 companies) of the cases, based on the latest available audited financial statements prior to liquidation. These results correspond with the results of research studies performed in the United Kingdom and the United States (see table 4-4).

To determine if the issuance of Statement on Auditing Standards AU 294, *Going concern* (SAICA 1986) had any effect on the auditor's qualifying behaviour, the above-mentioned 20 companies were subdivided into two groups:

- (1) the pre-AU 294 group, representing those companies whose audit reports were issued before the issuance of AU 294 in September 1986
- (2) the post-AU 294 group, representing those companies whose audit reports were issued after the issuance of AU 294

Nine of the 20 failed companies fell into the pre-AU 294 group. The auditor's opinions indicated going concern problems in 55,6 percent (five of the nine companies) of the cases. Eleven of the 20 failed companies fell into the post-AU 294 group. However, not one of these 11 failed companies' audit reports were qualified for going concern problems.

⁸ Difficulties were experienced in obtaining the financial statements of these companies. Although section 302 of the Companies Act No 61 of 1973, requires a public company to send a certified copy of the annual financial statements to the Registrar of Companies, none of these financial statements could be obtained from the Registrar. On discussion with the Registrar it was established that they do not have the necessary funds or human resources available to follow up on companies that do not send copies of their financial statements to the Registrar. The financial statements that could be located were obtained from the Bureau for Financial Analysis, University of Pretoria.

Auditors were thus more likely to issue going concern modified audit reports for bankrupt companies prior to failure in the pre-AU 294 period than in the post-AU 294 period.⁹ Thus the issuance of AU 294 (SAICA 1986) did have an effect on the auditor's qualifying behaviour, but not in the direction that one would have expected. To find a rationale for this is difficult. It can be hypothesised that AU 294 (SAICA 1986) does not provide sufficient guidance to the auditor in the evaluation and reporting of the going concern assumption.

To find a reason for this, the foreseeable future period for the post-AU 294 group was also analysed (see appendix A, table A-2). According to AU 294 (SAICA 1986:04), the auditor has a responsibility to evaluate information relating to one year after the balance sheet date or a minimum of six months following the date of the audit report, whichever is the later. This period represents the foreseeable future period that the auditor should consider in evaluating the going concern assumption.

In the survey conducted, the provisional liquidation dates of the 11 companies in the post-AU 294 period were taken as the date of failure and compared with the foreseeable future period. The results indicated that only two of the 11 companies (18 percent) failed within the foreseeable future period without their audit reports being qualified for going concern problems. Thus in 82 percent (nine of the 11 companies) of the cases, the auditor appears to have complied with AU 294 (SAICA 1986) by considering information relating to the foreseeable future period.

⁹ This is in contrast to the results of a study done by Raghunandan and Rama (1995) in the United States of America on the issuance of SAS No 59 (see sec 3.2.1).

However, the following important points should be noted:

- (1) AU 294 (SAICA 1986:04) states specifically that it would also be necessary for the auditor to take account of events which will or are likely to occur later than the foreseeable future period.
- (2) The liquidation date represents the final stage of the business failure process and is de facto evidence that the going concern assumption is invalid (see sec 2.5).
- (3) Some time before this final stage, the company shows warning signs¹⁰ that it is approaching a state of severe financial distress, which is evidence that there is substantial to very substantial doubt about the going concern assumption (see sec 2.5.2).
- (4) How long before the final stage of business failure does the company show warning signs of substantial changes in its financial health? Some researchers found that the company can show warning signs of financial failure five to 10 years before failure (see sec 2.5.2).

Therefore use of the provisional liquidation date as a criterion to measure if the auditor complied with AU 294 (SAICA 1986) by considering information relating to the foreseeable future period could produce misleading results because of the above-mentioned points.

By analysing the period beyond the foreseeable future period until the failure date (provisional liquidation date) for the nine companies that did not fail within the foreseeable future period, it was found that (see appendix A, table A-2)

¹⁰ For example, if there is a moderate or low probability that management's plans will succeed in overcoming the entity's problems, or if these plans fail.

- * four of the nine companies failed within six months after the foreseeable future period
- * four of the nine companies failed within six to 10 months after the foreseeable future period
- * one company failed 17 months and four days after the foreseeable future period

Taking into account that at some time before the failure date a situation of substantial doubt about the going concern assumption must have existed, inferences can be made that it is possible that the situation already existed in the foreseeable future period for

- * the companies failing within six months after the foreseeable future period
- * the companies failing within six to 10 months after the foreseeable future period

Therefore stating that the auditor was correct in 82 percent of the cases for not qualifying the audit report for going concern problems, because he or she complied with AU 294 (SAICA 1986) and considered information relating to the foreseeable future period, could thus be misleading.

The auditing standards issued by the United Kingdom (ICAEW 1994:13) and Australia (AARF 1996:09) require the directors to consider a future period, but state that it is not possible to specify a minimum length for the foreseeable future and 'that any such period would be artificial and arbitrary since in reality there is no "cut off" point'. The auditor must assess the reasonability of this period (see sec 3.4). The Australian auditing standard, AUS 708 (AARF 1996:04), also requires the auditor to focus his or her audit work on anticipated events occurring from the date of

the auditor's current report to the expected date of the auditor's report for the next annual reporting period. This therefore represents a period of approximately six months longer than that specifically required by the South African auditing standard.

Applying the foreseeable future period of AUS 708 (AARF 1996) to the survey conducted in this study would result in 54,5 percent (six of the 11) of the companies failing in the foreseeable future period without having their audit reports qualified for going concern problems. The 54,5 percent are compared to the 18 percent applying the foreseeable future period of AU 294 (SAICA 1986). Thus it can be concluded that AU 294 (SAICA 1986) should be revised to provide better guidance to the auditor.

4.4.5 Summary of the auditor's failure to issue the appropriate going concern qualification

This section indicated that less than 50 percent of companies that failed received a going concern qualification for the last financial statements issued prior to failure, whereas the majority of companies that received a going concern qualification did not subsequently fail. Shortcomings in the South African auditor's qualifying behaviour and in the guidance provided by AU 294 (SAICA 1986) have also been identified.

In direct contrast with the statistics reported, it was also indicated that failed companies that received a going concern qualification before failure were more acutely financially distressed and failed in shorter periods after the publication of the financial statements in comparison to failed companies that did not receive a going concern qualification before failure. The reasons for this were found to be that the weak financial status of the

company was public knowledge prior to the issuance of the going concern qualification, or the company's financial situation was so critical that the auditor would have been negligent to an exceptional degree if he did not issue a going concern qualification.

The question that should be asked here, is: 'Why do auditors not qualify the auditor's report before failure?' It has been argued that auditors do not qualify when there is uncertainty about the appropriateness of the going concern concept because of the consequences that the qualification could result in. The consequences that may possibly influence the auditor's decision to issue a going concern qualification are discussed in the next section.

4.5 THE CONSEQUENCES OF QUALIFYING THAT INFLUENCE THE AUDITOR'S DECISION TO ISSUE A GOING CONCERN QUALIFICATION

Kida (1980:516) examined the qualifying attitudes of audit partners and found that auditors who are more prone to issue going concern qualifications had stronger beliefs that the costs (consequences) of a Type I error would materialise, for example, a client's creditors would sue, grounds for alleging auditing negligence would be provided, the audit firm's reputation would be negatively influenced, and the auditor's responsibility would not be fulfilled (see sec 4.4.1). Audit partners who are more hesitant to issue going concern qualifications had stronger beliefs that the costs (consequences) of a Type II error would materialise, for example, they would lose the client, the client would sue, the audit firm's reputation would be negatively affected, and relations with the client

would deteriorate (see sec 4.4.2). However, both groups of auditors tended to believe that it is possible that a going concern qualification would cause the client to have going concern problems, reflecting the self-fulfilling argument.

The two more common consequences put forward in the literature for the auditor not qualifying when there is uncertainty about the appropriateness of the going concern assumption are the auditor's fear that:

- (1) the qualification will contribute to the client's problems and the downfall of the company (fear of the self-fulfilling prophecy)
- (2) the qualification will lead to a deterioration in relations with the client and the eventual loss of a client (fear of auditor switching)

These two consequences are discussed in this section.

4.5.1 Fear of the self-fulfilling prophecy

The auditor's fear of the self-fulfilling prophecy can be explained as the fear that the audit report itself, rather than the entity's condition, may actually lead to the failure of the business.

Various studies investigated whether the presence or absence of a going concern qualification is associated with the self-fulfilling prophecy argument. A distinction should be made between behavioural studies that examine auditors' perceptions of the likelihood that a going concern qualification becomes a self-fulfilling prophecy and studies reporting on the subsequent status of companies that have actually received a going concern qualification.

4.5.1.1 Studies reporting on auditors' perceptions of the likelihood that a going concern qualification becomes a self-fulfilling prophecy

The following statistics were obtained from behavioural studies examining auditors' perceptions of the likelihood that a going concern qualification becomes a self-fulfilling prophecy:

- * Kida's study (1980:517) reported that 61 percent of auditors indicated that they believe that a going concern qualification would cause problems for nonproblem entities, while 50 percent of auditors indicated that they believe that it would contribute to the difficulty already experienced by problem entities.
- * Mutchler's study (1984:24) reported that the majority of auditors did not agree with the self-fulfilling argument, and that they argued that the basic problems are already there and that the going concern qualification itself has nothing to do with the client going under. However, 37,5 percent of the auditors agreed with the concept.
- * Williams (1984:18) interviewed 15 audit partners of whom 73 percent indicated that they agree that a going concern qualification could lead to the failure of an entity.

The results of a study by Firth (1980) indicated that bankers and credit analysts attached great importance to going concern qualifications in audit reports and that the credit standing of a company with a going concern qualification was substantially impaired. The company's ability to obtain additional financing is thus affected, and this, could affect its ability to survive. Holt and Moizer (1990) also indicated that a going concern qualification caused increased uncertainty among users of financial statements because they feel less confident about the financial statements. If auditors are aware of the perceptions of users of financial statements on

going concern qualifications this may contribute to their reluctance to issue going concern qualifications.

Hence there is a perception among some auditors that a going concern qualification either causes or contributes to going concern problems, reflecting the self-fulfilling prophecy issue. Taffler and Tseung (1984: 268) draw the following conclusion in this regard:

Blaming the audit report in the case of failing companies is like shooting the messenger who rides in after the event with news which, as we have seen, in many cases is already common knowledge. Does the auditor believe that if he does not question whether the accounts of an insolvent company provide a "true and fair view" it will not fail? Bad management does not need the help of an audit report to bankrupt a business; it is perfectly capable of doing this itself.

4.5.1.2 Studies reporting on the subsequent status of companies that have received a going concern qualification

The results of the studies listed in table 4-5 (see sec 4.4.2) indicated that 70 percent or more of the companies that received going concern qualifications did not subsequently fail. Thus the results of these studies do not support the self-fulfilling prophecy; otherwise the majority of these companies would have failed.

Citron and Taffler (1992:344) compared companies that failed with going concern qualifications (21%) with a match group of companies that failed without going concern qualifications (22%). These results indicated that there is no evidence that failure is more likely to follow upon a going concern qualification than upon a nonqualified report, and once again the self-fulfilling prophecy is not supported.

Table 4-6 (see sec 4.4.3) indicates that companies with going concern qualifications fail in shorter periods after the publication of their accounts than companies without going concern qualifications. This appears to support the self-fulfilling prophecy. However, given the above-mentioned evidence that shows that the vast majority of companies issued with going concern qualifications do not subsequently fail, this argument would appear to lose some of its force.

4.5.2 Fear of auditor switching

The auditor's fear of auditor switching is based on the belief that companies would like to avoid receiving going concern qualifications and would, consequently, be prepared to change auditors to prevent it.

Various empirical studies investigated whether the presence of a going concern qualification is associated with the likelihood of auditor switching.

The following studies disclosed a positive relationship between the receipt of a qualified audit opinion and the propensity of entities to switch auditors in the following year:

- * Chow and Rice's study (1982:328) reported that 12,5 percent of companies with qualifications switched auditors in the following year. For the companies that did not receive qualifications, only three percent replaced their auditors in the subsequent year. Chow and Rice's study did not specify the type of qualifications issued to the companies.

- * Citron and Taffler's study (1992:343) reported that 13,1 percent of companies that received going concern qualifications switched auditors in the following year. Of the companies that did not receive qualifications, only 3,3 percent replaced their auditors.
- * Kida's study (1980:516) reported that audit partners who are more hesitant to issue a going concern qualification had stronger beliefs that they would lose the client.
- * Mutchler (1984:23) interviewed 16 audit partners of whom 62,5 percent indicated that they had lost clients because of the issuance of a going concern qualification.

The following studies could find no evidence that a going concern qualification leads to auditor switching:

- * Altman's study (1982:17) reported that a relatively small percentage of only 5,6 percent of the companies that received a going concern qualification changed their auditors. No comparison was given of auditor switching among unqualified companies.
- * Taffler and Tseung's study (1984:267) reported that one out of 21 (5%) companies with going concern qualifications mentioned that in the next year new auditors would be appointed. For the companies that did not receive going concern qualifications, eight percent indicated that they would be changing auditors in the next year.
- * Schwartz and Menon's study (1985:256) reported that 18 percent of companies with qualifications switched auditors. Of the companies that did not receive qualifications, 33 percent replaced their auditors. They could offer no meaningful interpretation of this unexpected finding. Schwartz and Menon's study did not specify the type of qualifications issued to the companies.

Schwartz and Menon (1985:255) also revealed that failing companies (26,5%) do have a greater tendency to switch auditors than healthier companies (9,8%). This is supported by Altman's study (1982:16) which indicated that a change in auditors occurred twice as often in companies that had actually entered bankruptcy (9%) than in those companies that had not entered bankruptcy (4%). Schwartz and Menon offered the following reasons for auditor switching by companies in financial distress:

- * More extensive auditing is required of a client in financial distress, which results in increased audit costs and may force management to search for an audit firm willing to perform the audit for a lower fee.
- * Companies in failing health may change auditors because of a need for different attributes comprising the audit package and to obtain better management advice.
- * There is a breakdown in the auditor-client relationship. The auditors interviewed in the Mutchler study (1984:23) also indicated that there is usually a long and heated discussion with management about the audit opinion, which leads to a breakdown in the auditor-client relationship.

The results of auditor switching after the issuance of a going concern qualification/audit qualification are thus not always consistent. However, there are some reported results supporting the fear of auditor switching. The auditor's independence is threatened by the fear of auditor switching. This ties up with the studies of McKeown, Mutchler and Hopwood (1991) and Mutchler (1986) which indicate that auditors more often issue going concern qualifications to smaller companies. This could suggest that the auditor's independence is influenced by the size of the client, for example that the auditor may be bowing to client pressure or that the auditor does not want to lose the audit fee.

4.5.3 Summary of the consequences of qualifying that influence the auditor's decision to issue a going concern qualification

This section has examined whether the consequences of issuing a going concern qualification would result in the qualification becoming a self-fulfilling prophecy or in the client switching auditors.

It has been indicated that the perceptual belief of the majority of auditors is that a going concern qualification would either cause or contribute to going concern problems, although the results of empirical studies could find no support for the self-fulfilling prophecy.

Studies conducted on whether companies change auditors after receiving going concern qualifications revealed inconsistent results. However, there appears to be a perceptual belief among some auditors that a going concern qualification could result in losing the client.

4.6 CONCLUSION

This chapter has reviewed empirical research studies that have been conducted on the auditor's judgment process in the presence of going concern uncertainties. This chapter indicated that the auditor's judgment process constitutes two separate stages of decision-making.

The first stage constitutes the auditor's identification of a going concern problem company by means of various going concern problem indicators. One may conclude that some of the indicators of going concern problems are regarded as more important than others by auditors in public practice,

and that auditors consider these indicators in the aggregate as well as the interaction between them in identifying a going concern problem company. The second stage constitutes the auditor's consideration and evaluation of management's plans to mitigate the going concern problem situation as well as any other factors that may aggravate the situation. The auditor then finds himself in a position to make a going concern decision.

Although auditors follow a formal decision-making process in making going concern judgments, as indicated in this chapter and as outlined in the professional auditing guidelines (see ch 3), they still fail to make the correct going concern decision for companies that fail and companies that survive. This chapter has indicated that some of the reasons for the auditor's failure to issue going concern qualifications, could be the auditor's fear that his client may switch auditors or that a going concern qualification would become a self-fulfilling prophecy.

Another reason that has been raised in the literature is whether the auditor does have the ability to make a going concern judgment. This will be discussed in the next chapter.



CHAPTER 5

THE AUDITOR'S ABILITY TO MAKE A GOING CONCERN JUDGMENT

5.1 INTRODUCTION

The previous chapter examined the auditor's decision-making process in the presence of going concern uncertainties. The chapter indicated that many companies that fail do not receive a going concern qualification for the last annual financial statements issued prior to bankruptcy, whereas many companies that do receive a going concern qualification do not subsequently fail. This has raised considerable scepticism about the auditor's ability to make going concern judgments.

It has been stated that auditors do not have the ability to assess whether an entity can remain in operational existence for the foreseeable future because of their limited experience in this area as clients fail only in isolated and infrequent instances (Bourne 1986:473; Taffler & Tseung 1984:268). However, auditors have maintained that an unqualified opinion about the financial statements is not a guarantee that the company has the ability to continue as a going concern and a going concern qualification is not a prediction of business failure (Altman 1982:8; Menon & Schwartz 1986:52).

The objective of this chapter is to examine the results of various empirical research studies that have been conducted to establish whether the auditor does have the ability to make going concern judgments. These empirical studies can be divided into three different groups according to the approaches employed, namely:

- (1) studies that use statistical models
- (2) behavioural studies
- (3) studies that use expert systems

5.2 STUDIES THAT EMPLOYED STATISTICAL MODELS TO EXAMINE THE AUDITOR'S ABILITY TO MAKE A GOING CONCERN JUDGMENT

The auditor's ability to make a going concern judgment has been examined by several empirical research studies, that have compared the auditor's going concern opinion issued in the audit report with a bankruptcy prediction model. The bankruptcy prediction models are based on certain key financial ratios to distinguish between bankrupt and nonbankrupt firms. A large body of literature has shown that statistical models utilising financial ratios can predict company failure with a reasonable degree of success. Zavgren (1983) and Jones (1987) provide reviews of this literature and propose various bankruptcy prediction models as being useful to auditors.

Altman and McGough (1974) were the first to provide the link between bankruptcy prediction models and auditors' going concern opinion decisions by comparing the accuracy of the model to auditors' opinions one year prior to the bankruptcy event. Several other studies were also conducted on this issue, the results of which indicate the auditor's ability to issue a going concern opinion to be inferior to the models (see table 5-1). Although these results appear to be significant, there are certain limitations and problems in the use of statistical models that have to be taken into account when comparing statistical models with the going concern opinions issued by auditors.

5.2.1 Limitations and problems in the use of statistical models

The following limitations and problems arise in the use of statistical models, and these have been noted in the literature:

- * The auditor's going concern opinion decisions are not isomorphic with bankruptcy predictions. Statistical models are developed to predict bankruptcy whereas auditors are mainly concerned with assessing the going concern status of a client and not predicting business failure.
- * The financial ratios used by the statistical models are not necessarily the ones identified by the auditors as being important.
- * Qualitative factors are not easily incorporated into statistical models and may be included by auditors in their going concern decisions.
- * The auditor's decision to issue a going concern qualification may be influenced by factors other than the likelihood of going concern problems, such as the perceived outcomes of qualifying or not qualifying.

These are discussed in more detail in the following sections.

TABLE 5-1
AUDITOR VERSUS MODEL ACCURACY
IN BANKRUPTCY PREDICTION ONE YEAR PRIOR TO THE EVENT

Study	Models' prediction accuracy	Auditors' opinion accuracy
Altman & McGough (1974:53)	82%	44%
Altman (1982:14)	86,2%	48,1%
Levitan & Knoblett (1985:31-37)	89,3%	66%
Koh & Killough (1990:189)	78,57%	21,43%

5.2.1.1 *Going concern decisions are not isomorphic with bankruptcy predictions*

The results of Kida's study (1980) indicated that the auditor outperformed the model as often as the model outperformed the auditor. The auditors in his study were able to discriminate *problem* from *nonproblem* firms, given only ratio data, with an average accuracy rate of 83 percent compared to the 90 percent accuracy rate of the statistical model. Kida refers to the results found by Altman and McGough (1974) between model (82%) and auditor (44%) accuracy and states that the 82 percent accuracy rate of the model refers to the prediction of problems, whereas the 44 percent accuracy rate of the auditor refers to the auditors' judgments of continuity qualifications, which are not the same as auditors' predictions of problem firms. He concludes that a comparison of bankruptcy model predictions with actual audit qualification decisions does not allow valid inferences to be drawn about the auditor's *ability* to identify problem companies as the auditor's going concern opinion decisions are not isomorphic with bankruptcy predictions.

Altman (1982:8) and Koh and Killough (1990:190) also state that the auditor is mainly concerned with assessing going concern problems and not predicting business failures. These studies pointed out that an assumption must be made when using failure prediction models, namely that expected failure and going concern problems are equivalent. Mutchler (1985:673) indicated that these two events are related, although there is not a one-to-one correlation.

It appears thus as if the results reported by the studies in table 5-1 are based on the assumption that expected failure and going concern problems are equivalent.

5.2.1.2 The financial ratios used by the statistical models are not necessarily the ones identified by auditors as being important

Levitan and Knoblett (1985) examined the question whether auditors used the same variables and weighing schemes as those of a bankruptcy prediction model. They examined a total of 26 variables consisting of indicators of going concern problems as suggested by SAS No 34 (AICPA 1981), as well as key financial ratios derived from previous bankruptcy studies. The results indicated that both the auditors and the bankruptcy prediction models used the ratio current years net worth/total debt, recurring negative cash flow and the slope of three years' current ratio as variables to distinguish between healthy firms and firms approaching bankruptcy. However, the most important ratio used in the bankruptcy model was the ratio of the slope of the three years' operating income/stockholders' equity, whereas the most important ratio used by the auditors was total debt/total assets. All these variables, except for the ratio of the slope of the three years' operating income/stockholders' equity, have been ranked by auditor subjects as being vital indicators of going concern problems (see sec 4.2.1). Thus the most important variable used in the bankruptcy model was not considered by the auditors as being important.

The bankruptcy prediction model used by Altman and McGough (1974) and Altman (1982) utilised the same five financial ratios. However, two of the five ratios used have been indicated by auditors as not being important as indicators of going concern problems, namely retained earnings/total assets and sales/total assets (see sec 4.2.1).

Chen and Shimerda (1981) identified seven groups and key representative ratios for each group for bankruptcy prediction utilising financial ratios. The seven groups identified are return on investment, capital turnover, financial leverage, short-term liquidity, cash position, inventory turnover and receivables turnover. They suggest that auditors should select one key ratio from each group to have a relatively complete ratio analysis approach but caution that the selection of more than one ratio from each group may lead to multi-collinearity among ratios and may cause the results to be sample-sensitive and possibly misleading. Boritz (1991) also states that the '...use of highly correlated ratios is both inefficient and potentially ineffective, since the inter-correlation or multi-collinearity of ratios can introduce instability into a statistical model'. The bankruptcy prediction model used by Koh and Killough (1990), for example, utilised 21 financial ratios consisting of four liquidity ratios, five profitability ratios, four leverage ratios, four activity ratios and four returns and market ratios. The results of the study of Koh and Killough reported in table 5-1 should thus be questioned for the possibility of whether multi-collinearity of ratios did not occur.

5.2.1.3 Qualitative factors are not easily incorporated into statistical models

Another limitation is that qualitative factors, such as management ability and future plans, the economic outlook of the industry and competitive developments are not easily incorporated into statistical models and may be included by auditors in their going concern decision (Koh & Killough 1990:190; Menon & Schwartz 1987:313). It has also been indicated in this study that the auditor does take into account qualitative factors in his decision to issue a going concern qualification (see sec 4.3.2). The professional auditing guidelines/standards also require the auditor to

consider indicators of going concern problems, which include qualitative factors, in the evaluation of the going concern status of an entity (see sec 3.4.2).

Keasey and Watson (1987) examined whether a model utilising a number of nonfinancial (qualitative) variables, either alone or in conjunction with financial ratios, can predict small company failure more accurately than a model based solely on financial ratios. Their results indicated that the model containing the ratios and nonfinancial variables was a better predictor of small company failure than the model containing financial ratios only. However, the nonfinancial variables incorporated in the model were based on historical publicly available information such as, whether any directors left during the three-year period, whether there was any change in auditors in three years and the average lag between the auditor's signature and submission. This study, however, has indicated that the going concern decision tends to be based on prospective information rather than historical information (see sec 4.3.2).

5.2.1.4 The auditor's decision not to issue a going concern qualification may be influenced by factors other than the likelihood of going concern problems

A comparison of bankruptcy model predictions with actual going concern qualification decisions may understate the auditor's ability to recognise problems. The reason being that an auditor's decision not to qualify a report may be influenced by factors other than the likelihood of going concern problems, such as the auditor's fear of losing the client, or that the client may sue, or that the audit firm's reputation may be negatively affected (see sec 4.5).

The studies of Kida (1980) and Campisi and Trotman (1985) provided empirical evidence to support this contention that auditors are sufficiently competent to formulate judgments about the ongoing ability of a business entity but that they do not qualify the financial statements in the light of going concern problems because of extraneous factors that influence their decision.

5.2.1.5 Methodological problems in the use of statistical models

Besides the above-mentioned limitations and problems, there are also certain methodological problems that statistical models suffer from.

Hopwood, McKeown and Mutchler (1994) re-examined the auditor versus model accuracy and criticise previous research, which has indicated the auditor's opinion to be inferior to models in predicting bankruptcy, as being not reflective of the auditor's real-world decision environment. Previous research is criticised on the following two points:

- (1) The samples of previous studies contained both stressed and nonstressed¹ firms. Hopwood et al (1994:411) partitioned their sample into stressed and nonstressed categories and refer to other research which also suggested '... that the standard statistical models do not apply simultaneously to both stressed and nonstressed firms and are not reflective of the auditors' decision problem.'
- (2) Samples are not drawn randomly but according to their status (ie bankrupt or nonbankrupt) (Koh & Oliga 1990:68). This result in an oversampling problem. Previous bankruptcy prediction studies have constructed samples using a 50 percent bankruptcy rate, a rate much

¹ A nonstressed firm is defined as a firm not showing any signs of financial distress.

higher than the one faced by auditors, which Zmijewski (1984:67) found to be less than one percent among listed firms.

After taking these two factors into account, the study of Hopwood, McKeown and Mutchler could find no evidence of the auditor being inferior to the model. Their results indicated that the auditor faces a different decision problem in stressed companies compared to nonstressed companies. None of the prediction methods applied in the study could predict the nonstressed companies. In another study by McKeown, Mutchler and Hopwood (1991:6) it was also found that none of the nonstressed companies received a going concern qualification. No significant differences were found between the model using only the stressed group and the auditors' actual opinions across a wide range of cost ratios.²

The result reported by the statistical model studies, namely that the auditor is inferior to the model, could thus not be accepted because of the significant limitations and problems experienced in the use of statistical models.

5.2.2 Advantages and usefulness of statistical models

Statistical models that accurately predict the going concern status of entities have the following advantages and uses for the auditor (Koh & Killough 1990:189; Koh & Oliga 1990:68):

² The cost ratio was defined as the ratio of the cost of misclassifying bankrupt companies to the cost of misclassifying nonbankrupt companies.

- * They provide objective and unambiguous information to supplement an auditor's subjective judgment in making going concern assessments.
- * They provide the auditor with guidelines on the appropriate ratios to consider and how to evaluate them.
- * They are an analytical tool that the auditor can use when discussing problems with a client and recommending changes in the financial statements.
- * They are a defensive device in the case of litigation.
- * They can be used at the beginning of the audit to make an initial risk assessment of the client in order to determine the necessary audit procedures.
- * They can be used at the end of the audit to assist in determining the type of audit opinion that is appropriate.

5.2.3 Summary of studies that employed statistical models

The results of empirical research studies have indicated that statistical models appear to be better indicators of financial failure than auditors' going concern opinions. This section, however, has indicated that there are certain limitations to and problems in the use of statistical models that make the comparison between failure prediction using statistical models and going concern opinions issued by auditors, questionable. One study could find no evidence of the auditor being inferior to the model after taking into account certain of these identified limitations. The auditor's ability to make a going concern judgment may thus be understated by statistical models and they should therefore not be used to examine the auditor's ability to make a going concern judgment.

Boritz (1991:131) draws the same conclusion:

In summary, bankruptcy prediction models by themselves may not be appropriate benchmarks to use for evaluating auditor performance since auditors' judgments may be the result of a complex set of considerations in which the raw probability of bankruptcy is only one factor.

This does not mean that the auditor should not use statistical models at all. Statistical models do have certain advantages and uses for the auditor in making going concern evaluations, for example, providing him with objective information. However, they should not replace the auditor's professional judgment but should rather supplement it.

The limitations of and problems experienced in the use of statistical models provide a point of departure for behavioural studies (see sec 5.3) and expert systems studies (see sec 5.4) to examine the auditor's ability to make going concern judgments.

5.3 BEHAVIOURAL STUDIES THAT EXAMINED THE AUDITOR'S ABILITY TO MAKE A GOING CONCERN JUDGMENT

Audit partners and managers have been used as subjects in behavioural studies to examine the auditor's ability to make a going concern judgment. Two main types of research methodologies or techniques are applied by researchers to study the quality of auditor judgment, namely ANOVA analysis and protocol analysis (Choo 1989:107). In ANOVA analysis, a set of accounting/auditing cases that are systematically different from each other is constructed and presented to the auditors. The researcher observes how an individual auditor's judgments change from case to case. In

protocol analysis, auditors think aloud into a tape recorder while performing the experiment task. The researcher analyses the verbal protocol data collected. The studies discussed in this section have employed these techniques to study the auditor's going concern judgment.

5.3.1 Studies that examined the auditor's professional judgment in general

Choo (1989) reviewed research studies that examined the differences in knowledge structuring and judgment competence between expert and novice auditors. Although the studies reviewed by Choo examined auditor judgment in general and not specifically in the context of a going concern situation, they give one insight into the difference between expert-novice knowledge structuring and decision making. A summary of the main findings of these research studies reviewed by Choo is given in appendix B.

From these findings it is clear that the expert auditors used a more scientific approach in acquiring and integrating information lacking among the novice auditors. In the actual judgment performance the expert auditors showed more confidence in the decisions made by them than the novice auditors. Significant differences were also found between the expert and novice auditors when confronted with judgments to be made in semistructured and unstructured tasks.

5.3.2 Studies that examined the auditor's professional going concern judgment

5.3.2.1 The study of Campisi and Trotman

Campisi and Trotman (1985) examined the performance of auditors when formulating going concern judgments. They compared the level of consensus among auditors who had an average experience of 10,3 years among them. By way of ANOVA analysis the results indicated that the auditors were able to reach a relatively high level of consensus when formulating going concern judgments. The study thus provided some empirical evidence that auditors are sufficiently competent to formulate judgments about the ability of an entity to continue as a going concern.

5.3.2.2 The study of Choo and Trotman

Choo and Trotman (1991) examined the relationship between knowledge structure and judgment competence, in the context of a going concern situation, for experienced and inexperienced auditors. Seniors with an average of 4,4 years of experience were recruited as experienced auditors whereas the inexperienced auditors had had less than six months of practical experience. The subjects had to recall typical and atypical information in the context of the going concern situation. Typical information is an item likely to exist (occur) for a company with going concern problems and atypical information is an item unlikely to exist (occur) for a company with going concern problems.

The results of the study indicated that there are differences between experienced and inexperienced auditors

- * in the amounts, type and clustering of items recalled
- * in the inferences made by them

The inferences made by the experienced auditors were significantly correlated with predictive judgments and the clustering of items recalled. This implies that the inferences made by the experienced auditors are contingent upon the degree to which they organise memory by a particular type of information. The study of Choo and Trotman may be criticised given that, for most firms, going concern decisions are performed by audit managers and partners with significantly more experience than only 4,4 years.

5.3.2.3 The study of Bonner and Pennington

Bonner and Pennington (1991) refer to the mixed results found by prior research studies on the evaluation of going concern issues performed by expert auditors. Some studies found high levels of performance among expert auditors whereas others found low levels of performance. Their study offers two possible explanations for the mixed results, namely the *types of cognitive processing* and *knowledge* needed for evaluating going concern issues.

The first explanation offered by Bonner and Pennington's study (1991:37) was that the type of cognitive processing required for the task affected performance. They found that experts perform better in tasks:

- * requiring *construction* processes rather than *reduction* processes.
(A construction process involves information retrieval and comprehension, hypothesis generation and design. A reduction process reduces information to obtain an evaluation of a hypothesis, estimate or choice.)
- * requiring or allowing for *theory-driven* reasoning rather than *statistical* reasoning.

The second explanation offered by Bonner and Pennington's study (1991:37), was that the quality of knowledge is an important determinant of expert performance. They found that experts performed better in tasks:

- * processing on the basis of *well-structured* knowledge as opposed to processing on the basis of *impoverished* knowledge. (Structured knowledge refers to knowledge that is well organised but not necessarily extensive. Impoverished knowledge lacks either structure or depth.)
- * with good learning environments for the initial acquisition of the knowledge needed. (Good learning environments include extensive instruction prior to practice and feedback, that is timely, accurate, complete and useful.)

When applying these two explanations to going concern issues, Bonner and Pennington (1991:24) found that auditors perform well in *gaining knowledge* of going concern issues and that they perform poorly in *evaluating* going concern issues. The reasons are as follows:

- * Gaining knowledge of a going concern issue requires a construction process and allows for theory-driven reasoning, both being tasks in which auditors tend to perform well.
- * Evaluating going concern issues requires a reduction process and allows for statistical reasoning, both of which are tasks in which auditors tend to perform poorly.

The study indicated that auditors possess a well-structured knowledge base for gaining knowledge of and evaluating going concern issues. A strong relationship was found between learning environment and performance, which suggests that auditors perform poorly in evaluating going concern issues because they do not have good opportunities to acquire knowledge in evaluating going concern issues. It was estimated by 23 experienced auditors of a 'Big Six' firm that only 25,3 percent of the knowledge needed for evaluating going concern issues was gained through instruction versus practical experience.

5.3.2.4 The study of Bonner

Bonner (1994) examined the effects of task complexity on audit judgment performance. She found that an increase in task complexity/skill leads to a decrease in judgment performance. Task complexity/skill was significantly negatively related to performance on going concern evaluations. Bonner suggests that judgment performance could be improved by:

- * restructuring the task with a decision aid or other appropriate devices
- * making changes in training programmes for auditors
- * assigning tasks to auditors with the necessary experience according to the complexity of the task

5.3.3 Studies that examined ‘Big Eight’/‘Big Six’ auditors’ abilities to make going concern judgments

The difference in qualifying attitudes of auditors from ‘Big Eight’/‘Big Six’ audit firms versus auditors from other audit firms was examined by various empirical studies.

Menon and Schwartz (1986:51) found that auditors from the ‘Big Eight’ audit firms had a greater tendency to issue going concern qualifications although the differences were not statistically significant. O’Clock and Devine (1995:205) reported that auditors from one ‘Big Six’ firm were more likely to issue going concern qualifications than auditors from other ‘non-Big Six’ firms. In contrast to these two studies, Citron and Taffler (1992:344) and Taffler and Tseung (1984:264) did not find a difference in qualification rates between auditors from the big international firms and other audit firms.

Thus because of the inconsistency in the results reported by these studies, no conclusion could be drawn about whether auditors from ‘Big Eight’/‘Big Six’ audit firms are in a better position to issue going concern qualifications.

5.3.4 Studies that examined the impact of hypothesis framing on the auditor’s going concern judgment

Hypothesis framing suggests that changes in the presentation or wording of a task can alter a person’s reference point, thereby affecting the decision alternative selected. General studies in psychology on the effect of hypothesis framing have reported a tendency for subjects to adopt

confirmatory strategies. A confirmatory strategy can be defined as a tendency by subjects to preferentially solicit evidence which tends to confirm rather than disconfirm one's hypothesis (Asare 1990:53).

The results of studies in auditing on the going concern issue provide weak support for a confirmatory strategy in hypothesis testing by experienced auditors (Asare 1990; Kida 1984; Trotman & Sng 1989). It should be noted, however, that the subjects of all three of these studies were audit partners and managers from international/'Big Eight'/'Big Six' audit firms.

In contrast, a study by O'Clock and Devine (1995) employed 47 subjects associated with a local or regional audit firm, 70 subjects associated with a large non-'Big Six' firm and 44 subjects associated with a 'Big Six' firm. The auditor subjects were asked to evaluate the going concern status of a client and to make a decision about whether the audit report should be modified. Continued bank financing was directly dependent on the client firm's ability to expand its customer base. One group of auditor subjects was told that there was a 30 percent chance that contract negotiations with a potential new customer would fail (negatively framed information), whereas the other group was told that there was a 70 percent chance that contract negotiations would be successfully completed (positively framed information). The results indicated that the auditor subjects from the local/regional firms and the large non-Big Six firm were susceptible to hypothesis framing. Consistent with the results of the three above-mentioned studies, framing effects were not significant among the 'Big Six' auditor subjects. One possible explanation offered by O'Clock and Devine for this finding is that auditors from 'Big Six' firms may have been alerted to potential framing biases through their training programmes, which should lead to implementation of strategies and procedures to mitigate the effect thereof in the decision-making process.

5.3.5 Studies that examined the sequence in which the auditor evaluated the going concern evidence

The sequence in which evidence is evaluated suggests that the order in which the auditor evaluates contrary information and mitigating factors affects his going concern judgment. General studies in psychology on the sequence in which evidence is evaluated have reported that a mixed sequence of complex evidence produces recency effects in evidence evaluation. Recency can be defined as implying 'that greater weight is given to confirming evidence when it is processed after disconfirming evidence rather than before' (Asare 1992:383).

The results of studies conducted in auditing on the going concern issue confirm that recency effects do occur in auditors' going concern judgments, namely that greater weight is given to mitigating factors when they are evaluated after contrary information rather than before (Asare 1992; Asare 1990³). The results of Asare's study (1992:390) indicated that the recency effect was also manifested in the auditors' opinion choice. Auditors who first evaluated contrary information followed by mitigating factors issued more unqualified opinions than those who did it in the reverse order.

The findings of the above-mentioned studies have important practical and theoretical implications. The auditing statements, for example, recommend that auditors should first evaluate conditions (including any mitigating factors) that cast doubt on the client's continuity status, and then obtain information about management plans to mitigate those conditions. Several auditor subjects in Asare's study (1992:391) recalled audits for which they

³ Asare (1990) refers to the results of a study by Messier, WF Jr in 1990, and which was presented as a working paper at the University of Florida.

had planned to issue a qualified audit report but changed their plans when the client obtained a new line of credit or waiver from a key creditor at the last minute.

5.3.6 Summary of the behavioural studies that examined the auditor's ability to make a going concern judgment

If one considers that auditors responsible for making going concern judgments are usually at partner or manager level, one may conclude that these auditors are experts. This section has indicated that expert auditors use a more scientific approach than novice auditors to acquire and integrate information in making professional judgments. Expert auditors are also better able to make professional judgments when confronted with semistructured and unstructured tasks, and compared to novice auditors, show more confidence in the judgments they make.

The behavioural studies in this section have reported mixed results on the auditor's ability to make going concern judgments. Some studies found high levels of performance by expert auditors while others found low levels of performance. It was indicated that auditors performed well in gaining knowledge of going concern issues but performed poorly in evaluating those issues because evaluation is a reduction process that has been indicated as a cognitive process in which experts generally tend to perform poorly.

It was also suggested that auditors perform poorly in evaluating going concern issues because they do not have good opportunities to acquire knowledge in evaluating going concern issues. This ties up with the statement made at the beginning of this chapter, namely that auditors are

incapable of making a going concern judgment because of their limited experience in this issue as clients fail only in isolated and infrequent instances. One study suggested that the auditor's judgment performance could be improved by using a decision aid, say, a statistical model, by improving the training programmes of auditors and that going concern judgments should be assigned to auditors with the necessary experience.

It was also indicated in this section that recency effects do occur in the auditor's going concern judgment, namely that greater weight is given to mitigating factors when they are evaluated after contrary information rather than before. The result is that auditors issue more unqualified opinions.

Because of the mixed results reported by these behavioural research studies, no conclusion can be drawn from the behavioural studies on whether the auditor does have the ability to make a going concern judgement.

Asare (1990:55) draws the same conclusion:

In sum, more behavioral research is needed to understand the decision processes of auditors making going-concern judgments, as well as to contribute to the debate on whether auditors are capable of evaluating their clients' going-concern status.

5.4 STUDIES THAT EMPLOYED EXPERT SYSTEMS TO EXAMINE THE AUDITOR'S ABILITY TO MAKE A GOING CONCERN JUDGMENT

Expert systems can be described as 'computer programs that solve unstructured problems requiring domain-specific knowledge' (Asare 1990:55). Boritz (1991:133) describes an expert system as one that permits 'rules of thumb (or heuristics) to be collected from experienced practitioners and statistical models, codified into computer processable logic expressions, often taking the form of IF...THEN rules, and applied to particular client circumstances'.

Research on expert systems is in an embryonic stage. A review of the literature indicated that three expert systems are currently being developed for the going concern decision, namely the GCX model, the AOD model and a rule-based prototype expert system developed at the University of Waterloo (Asare 1990:56; Boritz 1991:134; Messier & Hansen 1987:100).

5.4.1 The GCX model

The GCX model (Going Concern eXpert model) developed by Biggs, Selfridge and Krupka (1993) is a computational model that proposes that auditors possess and use three broad categories of client-based knowledge while making a going concern judgment, namely:

- * Financial knowledge consisting of
 - financial measures
 - company finances
- * Event knowledge consisting of
 - actual events⁴
 - normal events⁵
 - company operations⁶
- * Procedural knowledge consisting of four reasoning processes that *operate on the financial and event knowledge*, namely
 - recognising going concern problems
 - casual reasoning about going concern problems
 - evaluative reasoning about plans to mitigate problems
 - rendering a going concern judgment

From the development of the GCX model it became clear that auditors were *intimately familiar* with events that affected the client and that these events were critical to their going concern decision. 'Thus, it is proposed that client-based knowledge plays a critical role in auditor judgment and that research into auditor expertise that ignores this type of knowledge is incomplete' (Biggs et al 1993:86).

⁴ Auditors possess knowledge of actual events occurring in the client's environment and understand how those events affect the client's business.

⁵ Auditors know the normal pattern of events involved with the operating and financing activities of the client.

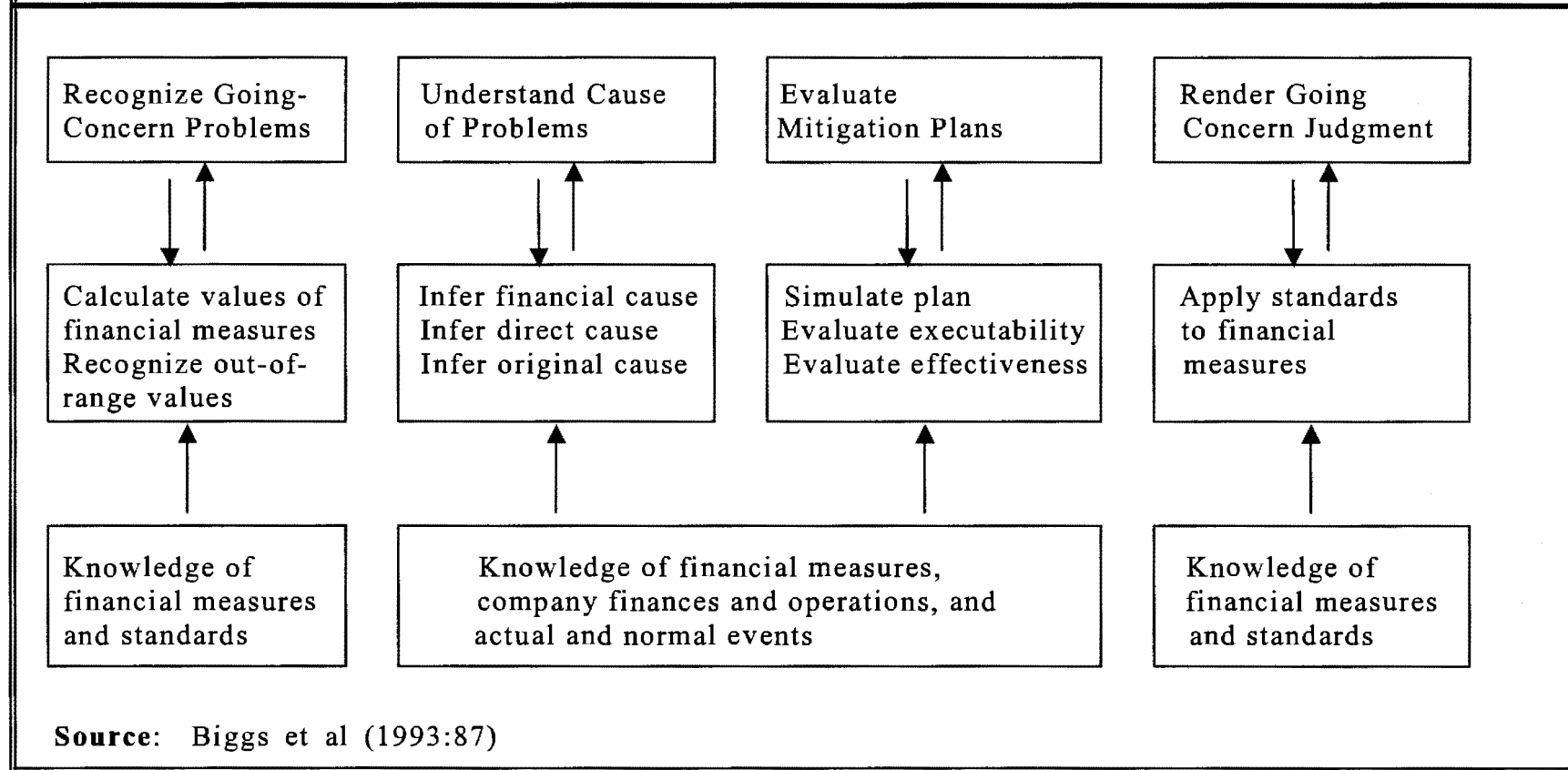
⁶ Auditors understand the client's operations and are able to reason about the financial effects of the operations.

This ties up with the views of audit partners interviewed by Mutchler (1984:23), who indicated that they consider all the information needed to make a going concern decision to be found on the financial statements, except for information about forecasts and management performances which requires *intimate knowledge* about the client.

Figure 5-1 illustrates the GCX model as a sequence of the four reasoning processes that operate on the financial and event knowledge and which the auditor uses to make the going concern judgment.

The GCX model proposes that the *first* reasoning process is the recognition of a going concern problem, which involves knowledge of financial measures and the ability to reason with that knowledge. The *second* reasoning process is the casual reasoning about the going concern problem, which identifies events as the underlying causes of the recognised going concern problem. This process involves all five types of financial (financial measures, company finances) and event (actual events, normal events, company operations) knowledge. The *third* reasoning process is the evaluative reasoning about management plans to mitigate the going concern problem and requires information about business and environmental factors and involves future factors that are difficult to predict. The GCX model breaks down this process into two questions, namely is the plan executable and is the plan effective? The *fourth* reasoning process is the rendering of the going concern judgment, which may be either 'going' if the client has no going concern problems; or 'not going' if the client has problems and there are either no plans to mitigate them or the plans are judged to be ineffective; or 'going conditional on' if the client has problems and plans to mitigate them are judged to be effective.

FIGURE 5-1
THE GCX MODEL



An evaluation of the GCX model indicates that the model's output closely parallels the output of the expert auditor and that it is a valuable research tool for understanding expert auditor judgment.

5.4.2 The AOD model

The AOD model (Audit Opinion Decision model) was developed by JF Dillard and JF Mutchler to assist the auditor in making going concern opinion judgments (Asare 1990:56; Messier & Hansen 1987:100). The knowledge-based expert system was constructed from authoritative pronouncements and verbal protocols collected from audit experts. The AOD system is a network of frames, each representing a decision-action state through which the auditor is guided with suggestions, rules and methods for making the going concern judgment. Both Asare and Messier and Hansen state that the AOD model is currently being adapted for PC implementation but neither one of them refer to the performance of the AOD model or its testing.

5.4.3 The prototype rule-based expert system

Boritz (1991:134) refers to a prototype rule-based expert system that was developed at the University of Waterloo for assessing going concern problems. The prototype expert system was constructed from consultations with experienced auditors, a review of relevant academic and practitioner literature, as well as a review of professional standards. Some 200 rules were incorporated into the system and divided into six categories:

- (1) debt structure and liquidity factors
- (2) operating factors
- (3) other financial indicators
- (4) management
- (5) nonfinancial internal factors
- (6) external factors

Figure 5-2 illustrates the rules for the prototype expert system. The rules were incorporated into the system by using a decision tree format for each one of the categories. Various questions are posed in the decision trees and lead to the accumulation of risk points. The auditor evaluates the accumulated risk points to determine the range in which the entity falls. A risk score (R) greater than 33 indicates a going concern problem, a score of 8 to 33 indicates a going concern problem mitigated by other factors, and a score below 8 indicates no going concern problem.

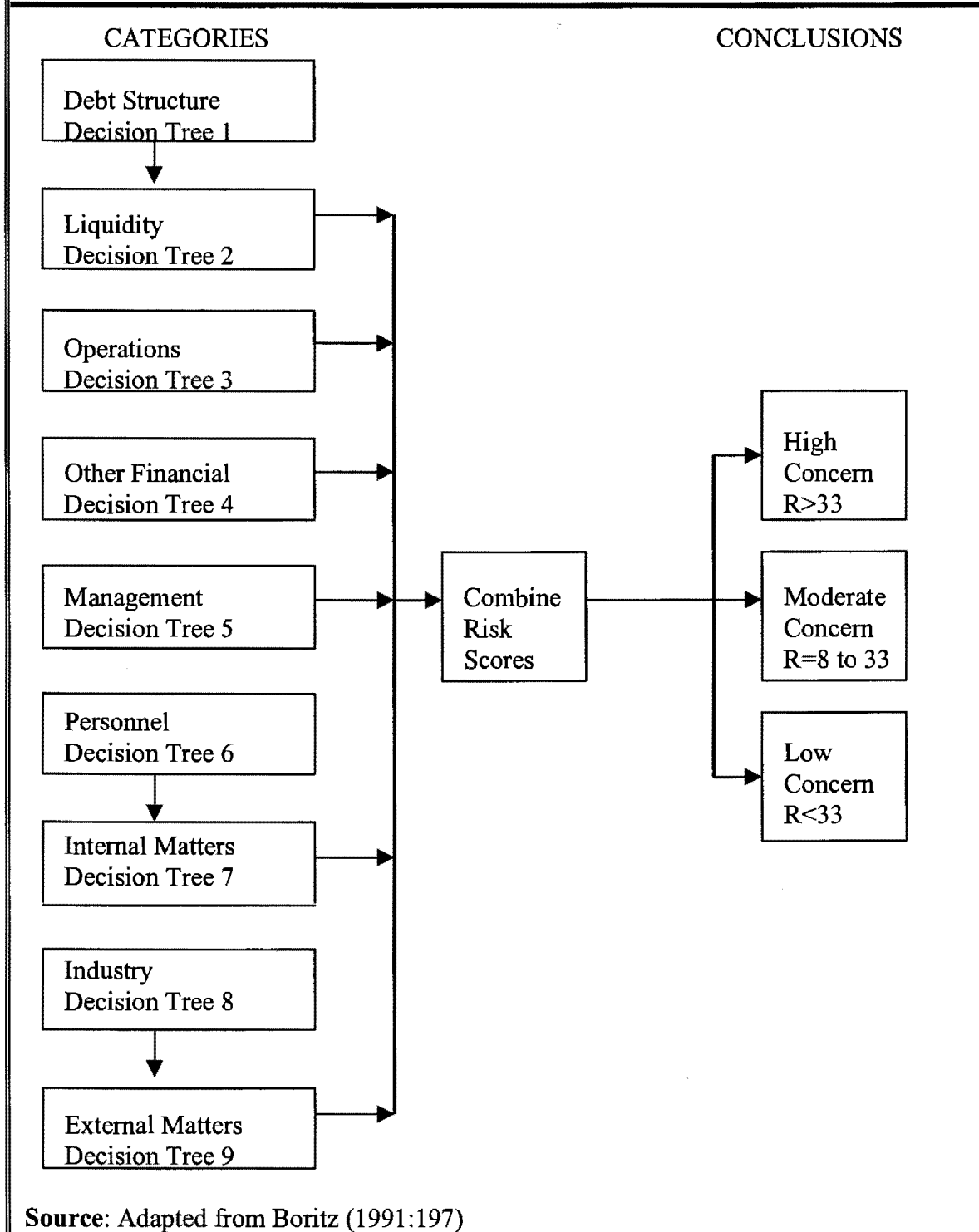
The system was subsequently tested on ten actual clients of a large auditing firm and in eight of the ten cases the output of the system paralleled the judgment of an expert auditor.

5.4.4 Summary of studies that employed expert systems to examine the auditor's ability to make a going concern judgment

Although there is limited information on expert systems, one may conclude that expert systems research provides an important avenue for understanding auditors' going concern judgments. Expert systems are an improvement on statistical models because they incorporate both quantitative and qualitative factors to examine what knowledge and

FIGURE 5-2

RULES FOR PROTOTYPE GOING CONCERN EXPERT SYSTEM



reasoning skills an expert auditor uses to make going concern judgments.⁷ An important qualitative factor identified by the expert systems that the auditor uses in making going concern judgments, is the auditor's intimate knowledge of the client's affairs.

A limitation of expert systems that should be noted, however, is that the system is only as effective as the person/people who designs/design it, the experts upon which the system is built, and the auditor who uses it (Boritz 1991:135; Choo 1989:107). Expert systems should thus not replace the auditor's professional judgment but should rather be used by the auditor as a decision-making aid in going concern judgments. Messier and Hansen (1987:95) draw the same conclusion:

Expert systems are computer programs that solve complex problems that require some type of expertise. Expert systems in auditing are intended to support, not replace, the auditor. As such, we classify them as a type of decision aid.

5.5 CONCLUSION

This chapter has reviewed empirical research studies, consisting of studies employing statistical models, behavioural studies and studies employing expert systems, that have been conducted to establish whether or not the auditor has the ability to make going concern judgments.

⁷ One of the limitations of statistical models is that qualitative factors are not easily incorporated into statistical models (see sec 5.2).

On the basis of the results employing statistical models and expert systems it appears as if auditors do have the ability to make going concern judgments. No definite conclusion can be drawn about whether auditors do or do not have the ability to make going concern judgments based on the results of the behavioural studies. However, one may conclude that both statistical models and expert systems may be valuable decision-making aids for the auditor in *objective* going concern judgments and should be employed as such. They should not replace the auditor's professional judgment.



CHAPTER 6

SUMMARY OF RESULTS, CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

The problem examined in this study involves auditors' failure to issue the appropriate opinion in the audit report on the going concern assumption underlying the financial statements. The failure to issue the appropriate opinion in the audit report can be classified as one of the following mistakes made by auditors in exercising their professional judgment about the validity of the going concern assumption:

- (1) The misclassification of a nongoing concern as a going concern.
- (2) The misclassification of a going concern as a nongoing concern.

The following hypotheses were formulated in chapter 1 in search for the underlying causes why auditors fail to make the appropriate professional judgment about the validity of the going concern assumption underlying the financial statements:

- (1) The professional auditing standards do not provide sufficient guidance to auditors to make a going concern judgment.
- (2) Auditors do not qualify when there is uncertainty about the validity of the going concern assumption because of the possible consequences of the qualification.
- (3) Auditors do not have the ability to make a professional judgment about the continued existence of an entity as a going concern.

The objective of this chapter is to summarise the results of this research addressing the problem and hypotheses formulated, draw conclusions and make recommendations from the results, and also suggest future extensions of this research.

6.2 SUMMARY OF THE STUDY

As originally discussed in chapter 1, the overall purpose of this study is to establish

- (1) whether auditors in South Africa also fail to issue the appropriate audit opinion on the going concern assumption underlying the preparation of financial statements
- (2) the reasons for auditors' failure to issue the appropriate audit opinion on the going concern assumption underlying the preparation of financial statements

Five research objectives were formulated in chapter 1 and the following subsections include a summary of the research results pertaining to each research objective, with conclusions based on those results.

6.2.1 Research objective 1

Research objective 1 was originally formulated in chapter 1 as follows: Determine whether the professional auditing standards provide sufficient guidance to auditors in the evaluation and reporting of the going concern assumption.

In chapter 3 of this research, the professional auditing standards issued on the going concern assumption by the International Federation of Accountants, United States of America, United Kingdom, Canada and Australia were examined and compared with the South African auditing standard AU 294, *Going concern* (SAICA 1986) to determine if sufficient guidance is provided to auditors in the evaluation and reporting of the going concern assumption. In chapter 4, secondary data from empirical studies were examined to determine if auditors in public practice follow the guidelines set out by the auditing standards.

6.2.1.1 *The approach followed in the evaluation of the going concern assumption*

The examination revealed that almost every current professional auditing standard reviewed states that it is the active duty of auditors to evaluate an entity's ability to continue as a going concern (see sec 3.4.1). The active approach requires auditors to pursue a specific line of enquiry invoking vigorous testing of the going concern assumption during the planning of the audit, the performance of the audit procedures and the evaluation of the results. Statement AU 294 (SAICA 1986) states that it is the active duty of the auditor during the planning and final review stage of the audit to *consider* the risk that the going concern may be inappropriately applied.

6.2.1.2 Using liquidation as a criterion to evaluate the going concern assumption

The results of the literature review indicated that the liquidation date represents the final stage of the business failure process and is de facto evidence that the going concern assumption is invalid (see sec 2.5). At some time before this final stage the entity shows warning signs that it is approaching a state of severe financial distress, indicating that there is substantial to very substantial doubt about the going concern assumption. The examination of the professional auditing standards revealed that some of the auditing standards state specifically that they do not apply to an audit of financial statements based on the assumption of liquidation (see sec 2.3.7). The significance of this is that at a point in time before liquidation, the entity may be a nongoing concern and should be evaluated as such by the auditor.

6.2.1.3 The evaluation of indicators of going concern problems

The examination revealed that all the auditing standards reviewed supply auditors with lists of indicators of going concern problems (see sec 3.4.2). The literature review indicated that auditors consider these indicators in the aggregate as well as the interaction between these indicators in identifying an entity as having going concern problems (see sec 4.2.2).

Poor management has been cited in the literature as the initial cause of business failure (see sec 2.5.2.1 & 4.2.1.3). Most of the auditing standards reviewed do list 'loss of key management without replacement' as an operating indicator of going concern problems but do not elaborate on it. The Australian standard provides examples of poor management attributes that could lead to going concern problems.

Two financial indicators, namely 'enter receivership' (judicial management in South Africa) and 'enter reorganisation proceedings', have been identified as evidence that there is very substantial doubt about the going concern assumption (see sec 4.2.1.1). The auditing standards do not list these two criteria as indicators of going concern problems.

The results indicated that the default status of an entity is the most important financial indicator of going concern problems (see sec 4.2.1.1). The default status involves the process of restructuring debt and the entity's inability to meet interest/loan payments, to repay/renew borrowings approaching maturity and management's negotiations with creditors to reverse the default. Recurring losses were also identified as an important financial indicator of going concern problems. These financial evidence indicators are listed by the auditing standards as indicators of going concern problems.

Adverse key financial ratios are also listed by the auditing standards as indicators of going concern problems but do not provide any examples of such key ratios. The results indicated that financial ratios are historical information, which is not a determining factor that influences auditors' decision to issue or not to issue a going concern qualification (see sec 4.3.1). The reason for this is that they have intimate knowledge of the client, which allows for judgments to be made about management performance and management restructuring. However, auditors use financial ratios to identify going concern problems and regard the following key ratios as being important in identifying such problems (see sec 4.2.1.2):

- * current assets/current liabilities (current ratio)
- * quick assets/current liabilities (quick asset ratio)
- * cash flow/total debt
- * total debt/total assets
- * net income/net sales

A limitation of financial ratios that should be taken into account is the fact that they become less reliable as failure approaches because of the effect of creative accounting (see sec 2.5.2.1).

6.2.1.4 Audit procedures that the auditor must perform in the evaluation of the going concern assumption

The results of the examination revealed that some of the auditing standards that were reviewed provide examples of specific audit procedures that the auditor should perform in the evaluation of the going concern assumption (see sec 3.4.3). These auditing standards divide the specific audit procedures into two groups:

- (1) examples of audit procedures that may take on additional significance and/or should be extended or modified or it may be necessary to employ additional audit procedures, if indicators of going concern problems have been identified
- (2) examples of audit procedures to evaluate management's plans for future action to mitigate the going concern problem

The absence of such specific audit procedures has been identified in the literature as being one of the shortcomings of the auditing standards (see sec 3.2.1). Statement AU 294 (SAICA 1986) does not provide the auditor with any examples of audit procedures that should be performed in the evaluation of the going concern assumption.

6.2.1.5 Evaluation of management's plans dealing with the going concern problem

The results of the examination revealed that almost every auditing standard reviewed requires the auditor to evaluate management's plans for dealing with the adverse effects of the going concern problems (see sec 3.4.4). The auditing standards divide management's plans into four main areas, namely plans to dispose of assets, borrow money or restructure debt, reduce or delay expenditures and plans to increase ownership equity. Statement AU 294 (SAICA 1986) mentions these main four areas only, while some of the auditing statements provide examples of each main area.

The results of the literature review indicated that management's plans to borrow money or restructure debt are considered more important by auditors in public practice because the benefits derived from such plans realise most quickly (see sec 4.3.2). The results also indicated that if there is a low or moderate probability that management's plans will succeed, this creates substantial doubt in the auditors whether the entity is a going concern and influences their going concern decision.

6.2.1.6 The evaluation of the going concern assumption for the foreseeable future

The examination revealed that all the auditing standards reviewed require the auditor to evaluate information relating to the going concern assumption for the foreseeable future (see sec 2.3.7). The foreseeable future represents a reasonable period of time beyond the balance sheet date. The required length of the foreseeable future period to be considered by the auditor varies for each auditing standard reviewed. The general norm seems to be that a minimum period to be considered by the auditor represents a period of at least one year beyond the date of the financial statements.

The Australian auditing standard, AUS 708 (AARF 1996), requires the auditor to obtain audit evidence on the going concern assumption for a period of 12 months from the date of the auditor's current report to the expected date of the auditor's report for the next annual reporting period. According to AU 294 (SAICA 1986), the foreseeable future represents a period of one year after the balance sheet date or a minimum of six months following the date of the audit report, whichever is the later. Compared to AUS 708 (AARF 1996), it represents a period of approximately six months less than the South African auditor needs to consider. The results indicated that if the foreseeable future period as defined per AUS 708 (AARF 1996) is applied to the survey conducted in this study on South African companies, 54,5 percent of the companies fail within the foreseeable future period without having their audit reports qualified for going concern problems. This is compared to 18 percent applying the foreseeable future period of AU 294 (SAICA 1986). It can thus be concluded that the foreseeable future period defined by AU 294 (SAICA 1986) appears to be insufficient. It can also be concluded that the auditors in these cases did

not consider the events occurring later than the foreseeable future period, although AU 294 (SAICA 1986) specifically requires it.

The reason proffered in the literature for the inclusion of a time frame is that it ensures that auditors deal only with existing conditions and that the audit is not a prediction of future conditions or events, thereby reducing the audit risk (see sec 2.3.7 & 3.1). However, specifying a minimum or standard length for the foreseeable future period can be extremely risky, as this study indicated, because it could provide auditors with a scapegoat for their responsibilities not to consider events occurring later than the specified period. The United Kingdom auditing standard, SAS 130 (ICAEW 1994), states that it is not possible to specify a minimum length for the foreseeable future because it would be artificial and arbitrary to do so, since in reality there is no cut-off point. Depending on certain factors the cut-off point may also be different for each entity.

6.2.1.7 The reporting of the going concern assumption

The examination of the auditing standards revealed that the auditor's responsibility to report on the going concern assumption depends on whether the assumption is appropriate, questionable or inappropriate (see sec 3.5). The reporting requirements of AUS 708 (AARF 1996), ISA 570 (IFAC 1995), SAS No 59 (AICPA 1988b) and SAS 130 (ICAEW 1994) are all quite in line. The reporting requirements of CICA Handbook Section 5510 (CICA 1989) and AU 294 (SAICA 1986) differ from those of the above-mentioned auditing standards. However, the reporting requirements of SAAS 700, *The auditor's report on financial statements* (SAICA 1997c), supersede those of AU 294 (SAICA 1986) and are compatible with the above-mentioned auditing standards.

The comparison of the South African auditing standard with the auditing standards issued on the going concern by the International Federation of Accountants, United States of America, United Kingdom, Canada and Australia indicated the following two differences, which can be regarded as shortcomings in the reporting requirements of AU 294 (SAICA 1986) and which SAAS 700 (SAICA 1997c) does not address:

- (1) When consideration of mitigating factors and plans implemented by management have had a significant effect upon the auditor in forming the opinion that the going concern basis is appropriate, the auditor does not need to consider any disclosures in the financial statements.
- (2) The auditor has the option to issue an unqualified, qualified or adverse opinion if the going concern assumption is inappropriate.

In reporting on the going concern assumption the auditor must make a decision whether there is 'substantial' or 'significant' uncertainty/doubt about the entity's ability to continue as a going concern. However, the results of the review indicated that the auditing standards associated with the going concern assumption do not define 'substantial' or 'significant' uncertainty/doubt (see sec 3.2.1 & 3.5.4). It is left to the discretion of the auditor to decide when a situation of 'substantial' or 'significant' doubt exists. The literature review indicated that there is an expectations gap between auditors and users of financial statements regarding the meaning of substantial doubt (see sec 3.2.1). There is thus a need for these terms to be quantified in the auditing statements in clear and concise language. AU 294 (SAICA 1986) refrains from using the terms 'substantial' or 'significant'.

6.2.2 Research objective 2

Research objective 2 was originally formulated in chapter 1 as follows: Determine whether auditors in South Africa qualify the audit report for uncertainty about the going concern assumption and whether the issuance of Statement on Auditing Standards AU 294, *Going concern* (SAICA 1986) had any effect on the auditors' qualifying behaviour.

In section 4.4.4 of this research, an empirical study of industrial companies whose listings were terminated on the Johannesburg Stock Exchange because of financial failure was conducted to determine if auditors in South Africa qualify the audit report for uncertainty about the going concern assumption. The audit opinion issued in the audit report for the latest available audited financial statements prior to liquidation was examined.

It was found that in only 25 percent of the cases did the audit report indicate going concern problems. These results correspond with the results of studies performed in the United Kingdom and the United States of America and provide further compelling evidence that auditors fail to qualify the audit report for going concern uncertainties.

To determine if the issuance of Statement on Auditing Standards AU 294, *Going concern* (SAICA 1986) had any effect on the auditor's qualifying behaviour, the group of industrial companies was split into a pre-AU 294 and a post-AU 294 group. The results indicated that auditors were more likely to issue going concern modified audit reports for bankrupt companies prior to the failure in the pre-AU 294 period than in the post-AU 294 period. For the pre-AU 294 group the audit report indicated going concern problems in 55,6 percent of the cases. None of the audit reports of

the post-AU 294 group was modified for going concern problems.

To find a rationale for this, the foreseeable future period for the post-AU 294 group was also analysed. The provisional liquidation date was taken as the date of failure and compared with the foreseeable future period to determine if the company failed within the definition of the foreseeable future period as per AU 294 (SAICA 1986). The results indicated that 82 percent of the post-AU 294 group did not fail within the foreseeable future period. It can thus be concluded that the auditors of these companies acted within the parameters set by AU 294 (SAICA 1986) regarding the foreseeable future period.¹ However, AU 294 (SAICA 1986) also requires the auditor to take account of events that will or are likely to occur later than the foreseeable future period. The results indicated that 73 percent of the post-AU 294 group failed within 10 months after the foreseeable future period, and were not taken into account by the auditors.

It can thus be concluded that auditors in South Africa fail to qualify the audit report for uncertainty about the going concern assumption and that the issuance of AU 294 (SAICA 1986) did have an effect on the auditor's qualifying behaviour, but not in the direction one would have expected.

A limitation of the study that should be taken into account is the fact that the provisional liquidation date, which is de facto evidence that the going concern assumption is invalid, was used to determine whether the companies failed within the foreseeable future period. Research has shown that at some time before this date the company shows warning signs that it is approaching a state of severe financial distress. Therefore stating that the auditor was correct in 82 percent of the cases for not qualifying the

¹ The parameters set for the foreseeable future period by AU 294 have been shown to provide insufficient guidance to auditors (see sec 6.2.1.6).

audit report for going concern problems because the companies did not fail within the foreseeable future period, could be misleading.

6.2.3 Research objective 3

Research objective 3 was originally formulated in chapter 1 as follows: Determine whether the going concern qualification issued by auditors contributes to their clients' problems and the ultimate downfall of the company, resulting in a self-fulfilling prophecy.

In section 4.5.1, secondary data from empirical research studies were examined to determine whether the going concern qualification issued by auditors contributes to their clients' problems and the ultimate downfall of the company, resulting in a self-fulfilling prophecy.

The results indicated that there is a perception among some auditors that a going concern qualification is a self-fulfilling prophecy by either causing or contributing to the going concern problems of a client. It was also indicated that some users of financial statements attach so much importance to going concern qualifications in audit reports that the self-fulfilling prophecy is supported.

It can thus be concluded that the auditor is hesitant to issue a going concern qualification because of the self-fulfilling prophecy. However, the results of empirical studies that examined the subsequent status of companies that have received a going concern qualification could find no support for the self-fulfilling prophecy.

6.2.4 Research objective 4

Research objective 4 was originally formulated in chapter 1 as follows: Determine whether the going concern qualification issued by auditors is associated with the loss of the client, resulting in auditor switching.

In section 4.5.2, secondary data from empirical research studies were examined to determine whether the going concern qualification issued by the auditor is associated with the loss of the client, resulting in auditor switching.

Inconsistent results were obtained from studies examining the relationship between qualified audit opinions and auditor switching and studies examining unqualified audit opinions and auditor switching. It was also indicated that failing companies do have a greater tendency to switch auditors than healthier companies, not necessarily because of going concern qualifications but for other reasons. However, there are some reported results of auditor switching after the issuance of going concern qualifications, although these represent a relatively small percentage. Therefore on the basis of these results, no conclusion can be made whether a going concern qualification is associated with auditor switching.

6.2.5 Research objective 5

Research objective 5 was originally formulated in chapter 1 as follows: Determine whether auditors do have the ability to make professional going concern judgments.

In chapter 5, secondary data from empirical research studies were examined to determine whether the auditor does have the ability to make a professional going concern judgment.

6.2.5.1 Studies that employed statistical models to examine the auditor's ability to make a going concern judgment

The results of various empirical research studies have indicated that statistical models are better indicators of financial failure than auditors' going concern opinions issued in the audit reports (see table 5-1). The results of the literature review, however, have indicated that there are significant limitations to and problems in the use of statistical models that make the comparison between failure prediction using statistical models and going concern opinions issued by auditors, questionable (see sec 5.2.1). Studies that were conducted to address the limitations and problems could find no evidence that the auditor is inferior to the model. The auditor's ability to make a going concern judgment may thus be understated by statistical models predicting bankruptcy.

On the basis of these results employing statistical models, it can be concluded that auditors' going concern opinions are not inferior to statistical models and therefore that auditors' failure to issue the appropriate opinion on the going concern assumption, is not because they do not have the ability to make going concern judgments.

However, it has been indicated in this study that statistical models do have certain advantages and uses for the auditor and may be used as a valuable audit tool to make objective going concern judgments, but that such models should be supplementary and not replace the auditor's professional judgment. Use of statistical models would also eliminate the auditor's

evaluation problem identified in the next section, namely that evaluation allows for statistical reasoning that has been indicated as a cognitive process in which experts tend to perform poorly (see sec 6.2.5.2).

6.2.5.2 Behavioural studies that examined the auditor's ability to make a going concern judgment

The examination of the behavioural studies revealed mixed results on the auditor's ability to make going concern judgments (see sec 5.3). It was indicated that auditors performed well in gaining knowledge of going concern issues but performed poorly in evaluating such issues. The reason for this is that evaluation is a reduction process and allows for statistical reasoning that involves cognitive processes in which experts generally tend to perform poorly. It was also indicated that a strong relationship exists between learning environment and performance. This is another reason why auditors perform poorly in evaluating going concern issues on account of their limited experience in this issue because clients do not fail on a day-to-day basis but only in isolated and infrequent instances.

The results also indicated that recency effects do occur in the auditor's going concern judgment, namely that greater weight is attached to mitigating factors when they are evaluated *after* rather than *before* contrary information. The significance of this is that it is possible that auditors could issue more unqualified opinions. The auditing statements also require the auditor to consider mitigating factors, in particular management's plans for future action, the outcome of which is expected to improve the situation, as the last step in the going concern decision-making process just before forming the audit opinion.

Because of the mixed results reported by the behavioural research studies, no conclusion can be drawn on whether the auditor does have the ability to make a going concern judgement. However, it does appear as if auditors do lack experience in evaluating going concern issues, as clients do not fail every day.

6.2.5.3 Studies that employed expert systems to examine the auditor's ability to make a going concern judgment

The results of the review indicated that there is limited information available on expert systems because research in this area is in an embryonic stage (see sec 5.4). Three expert systems were identified, two of which were tested. The results of the systems tested revealed that it paralleled the judgment of an expert auditor.

The examination also revealed that expert systems are an improvement on statistical models because they incorporate both quantitative and qualitative factors to examine what knowledge and reasoning skills an expert auditor uses to make going concern judgments. One important qualitative factor, identified by the expert systems, that auditors use in making going concern judgments, is their intimate knowledge of the client's affairs which is not incorporated into statistical models.

A limitation of expert systems that should be noted, however, is that the system is only as effective as the person/people who designs/design it, the experts upon which the system is built, and the auditor who uses it.

6.3 CONCLUSION

On the basis of the results of this study, it can be concluded that auditors in South Africa fail to issue the appropriate audit opinion on the going concern assumption underlying the financial statements (see sec 6.2.2). The results of this study thus provide further compelling evidence that correspond with the results of studies performed in the United Kingdom and the United States of America, namely that auditors fail to issue the appropriate audit opinion on the going concern assumption underlying the financial statements.

The conclusions related to the hypotheses formulated in search for the reasons why auditors fail to issue the appropriate audit opinion on the going concern assumption are as follows:

- (1) The professional auditing standards reviewed in this study do provide guidance to auditors in the evaluation and reporting of the going concern assumption underlying the financial statements (see sec 6.2.1). However, it can be concluded that there are certain shortcomings in the guidance provided by the auditing standards (see secs 6.2.1.1 - 6.2.1.7), which could be a reason why auditors fail to issue the appropriate opinion on the going concern assumption. Hence, there appears to be some support for the first hypothesis formulated, namely that the professional auditing standards do not provide sufficient guidance to auditors to make a going concern judgment.
- (2) The results indicated that auditors are hesitant to issue going concern qualifications because they believe that this could result in a self-fulfilling prophecy (see sec 6.2.3). These results thus support the second hypothesis formulated, namely that auditors do not issue going

concern qualifications because of the possible consequences thereof. However, no conclusion can be drawn whether a going concern qualification results in auditor switching because inconsistent results were obtained from the examination (see sec 6.2.4).

- (3) The third hypothesis formulated, namely that auditors do not have the ability to make a professional going concern judgment can be rejected on the basis of the results employing statistical models and the results employing expert systems. These results indicated that the expert systems paralleled the going concern judgment of expert auditors and that the auditors' going concern opinions are not inferior to statistical models (see secs 6.2.5.1 & 6.2.5.3). However, on the basis of the results obtained from the behavioural research studies, the hypothesis can be partly accepted and partly rejected because the results indicated that auditors performed well in gaining knowledge of going concern problems but performed poorly in evaluating them (see sec 6.2.5.2). Evaluation entails cognitive processes in which experts tend to perform poorly and because auditors lack experience in evaluating going concern issues due to clients failing only in isolated and infrequent instances.

6.4 RECOMMENDATIONS

Three types of recommendations emerged from this study. The first group contains recommendations aimed at improving the guidance provided by the South African auditing standard AU 294, *Going concern* (SAICA 1986). The aim of the second group of recommendations is to make auditors in public practice aware of certain research results that can

improve their evaluation and reporting of the going concern assumption. The third group suggests areas for further research.

6.4.1 Recommendations pertaining to the South African auditing standard AU 294, Going concern

It is recommended that AU 294 (SAICA 1986) should be revised on the following matters:

- (1) AU 294 (SAICA 1986) should adopt a more definite active approach throughout the entire audit, namely during the planning, performance of audit procedures and final review stages. The wording used in paragraph 7, namely “consider the risk” should be replaced with more descriptive wording indicating an active action, namely “evaluating the risk” or “assessing the risk” that the going concern assumption underlying the financial statements may be inappropriately applied. The wording used in paragraph 8, namely the auditor should “be aware” that certain factors may indicate doubt about an entity’s ability to continue as a going concern should also be replaced with more descriptive wording indicating an active action, namely the auditor should “identify” such factors that may indicate doubt.
- (2) AU 294 (SAICA 1986) should be revised to specifically exclude the liquidation basis. The following paragraph serves as an example (AICPA 1988b): ‘This section [auditing statement] does not apply to an audit of financial statements based on the assumption of liquidation (for example, when [a] an entity is in the process of liquidation, [b] the owners have decided to commence dissolution or liquidation, or [c] legal proceedings, including bankruptcy, have reached a point at

which dissolution or liquidation is probable)'. The inclusion of such a paragraph will result in the auditor having to determine whether it is a going concern or not, prior to the entity going into liquidation.

- (3) The list of indicators of going concern problems provided in AU 294 (SAICA 1986) should be expanded to include, say, the following poor management attributes that could be indicators of going concern problems (AARF 1996):

- (a) a lack of strategic direction including appropriately documented policies, plans and forecasts such as forward budgets and cash flow projections
- (b) deficiencies in the governing body, such as a lack of independent members, a low level of involvement in key decisions, poor documentation and communication of decisions, imbalance or a lack of expertise among members
- (c) deficiencies in management information systems, including blockages in information flows, or lack of management action in response to information received
- (d) rapid or unplanned development of business (particularly in noncore activities) without commensurate developments in information systems, management expertise, financing structures, pricing policies, et cetera

It is also recommended that the list of indicators of going concern problems in AU 294 (SAICA 1986) should be expanded to include the following two financial indicators:

- (a) enter judicial management
- (b) enter reorganisation proceeding

- (4) AU 294 (SAICA 1986) should be revised to include specific examples of audit procedures that should be performed in the evaluation of the going concern assumption. AUS 708 (AARF 1996) provides detailed examples of such audit procedures that could be considered for inclusion (see secs 3.4.3 & 3.4.4).
- (5) AU 294 (SAICA 1986) should be revised to include more detailed examples of management's plans under each main area. AUS 708 (AARF 1996) provides detailed examples of such plans that could be considered for inclusion (see sec 3.4.4).
- (6) It is recommended that the foreseeable future period to which the auditor should pay attention in assessing the going concern assumption, as defined in AU 294 (SAICA 1986), should be revised and that due consideration should be given before specifying a minimum or standard length for this period. The foreseeable future period as defined by AUS 708 (AARF 1996) could be used as a guideline, namely a period of approximately 12 months from the date of the auditor's current report to the expected date of the auditor's report for the next annual reporting period. More emphasis should also be placed on the fact that auditors should also take account of events occurring shortly after the foreseeable period.
- (7) It is recommended that AU 294 (SAICA 1986) should be revised in order to be in line with the reporting requirements of SAAS 700 (SAICA 1997c). The following two aspects of the auditor's reporting responsibility also need to be revised:

- (a) If the going concern uncertainty is resolved because of mitigating factors, in particular management's plans, the auditor should consider the need for disclosure of such matters if it had a significant effect upon him or her in forming his or her opinion that the going concern assumption is appropriate. If the necessary disclosures are not made, the auditor should express a qualified opinion, 'except for' or express an adverse opinion.
 - (b) If the auditor concludes that the going concern assumption used in the preparation of the financial statements is inappropriate, he or she should express an adverse opinion.
- (8) Although AU 294 (SAICA 1986) does not refer to the terms, 'substantial' or 'significant' doubt at this stage, it is recommended that if these terms should be used in a revised auditing statement on the going concern assumption, they should be quantified in clear and concise language.

6.4.2 Recommendations pertaining to the auditor in public practice

It is recommended that auditors in public practice should be made aware of the results of empirical studies indicating that the majority of companies that received going concern qualifications did not subsequently fail, and therefore that this should not be a factor influencing the auditor's decision to issue a going concern qualification.

It is recommended that the auditor in public practice should make use of statistical models and/or expert systems as audit tools, to aid in making an objective evaluation of the going concern assumption. However, these audit tools should be supplementary and should not replace the auditor's professional judgment.

It is recommended that the auditor in public practice should follow formal training programmes to compensate for the lack in experience in evaluating going concern problems or that the services of an auditor, who is an expert in this area, should be acquired if a client experiences going concern problems.

It is recommended that the South African Institute of Chartered Accountants should encourage and assist auditors in public practice in becoming informed about the above-mentioned recommendations to support the professional judgment process regarding the going concern assumption.

6.4.3 Recommendations pertaining to future extensions of this research

Research opportunities that can make a useful contribution to the area of the going concern assumption are virtually unlimited. The South African auditor's responsibility regarding the going concern assumption in particular is a fertile field for empirical research.

The following are a few of the points arising from this study that can be highlighted:

- * Statement AU 294, *Going concern* (SAICA 1986), still needs to be revised to be compatible with the International Standards on auditing. Future research could be directed at the revised auditing statement on going concern to determine if the shortcomings identified in this study were addressed and if it provides sufficient guidance to auditors.
- * Research could be conducted to determine whether auditors in South Africa follow an active approach in evaluating the going concern assumption, and whether they use specific audit procedures or rely on their normal audit procedures to assess the going concern status of their clients.
- * Research could be conducted on the audit opinion issued to bankrupt companies in the period after the issuance of the guideline on corporate governance, *Guidance for directors: going concern and financial reporting* (SAICA 1997b). Research could determine whether the directors' increased responsibility to assess the going concern status of the company has any effect on the auditor's qualifying behaviour.
- * The empirical research in section 4.4.4 was confined to bankrupt companies delisted on the Johannesburg Stock Exchange (JSE). Future research could examine financially stressed nonbankrupt companies in South Africa to determine the type of audit opinion issued by the auditor.
- * The empirical research in section 4.4.4 dealt with the going concern status of industrial companies listed on the JSE. Future extensions of this research could include other sectors of the market or small companies not listed on the JSE.

- * The empirical research in section 4.4.4 examined the occurrence of a Type I error, the classification of a nongoing concern as a going concern. There is a need for research in South Africa to examine the occurrence of Type II errors, the classification of a going concern as a nongoing concern.
- * Further research needs to be done on whether a going concern qualification is associated with the loss of the client, resulting in auditor switching.
- * A major area for future research concerns expert systems to examine the auditor's going concern judgment. As indicated in section 5.4, limited information is available on expert systems because research in this area is in an embryonic stage.

6.5 General conclusion

The author hopes, firstly, that the recommendations arising from this study will make a useful contribution, no matter how small, to improving auditors' evaluation and reporting of the going concern assumption underlying financial statements; and secondly, that others will be inspired to conduct further research in this pertinent field of study.



APPENDIX A

SURVEY OF SOUTH AFRICAN COMPANIES WHOSE LISTINGS WERE TERMINATED ON THE JOHANNESBURG STOCK EXCHANGE OWING TO FINANCIAL FAILURE

As discussed in section 4.4.4 of chapter 4, the last annual reports issued before financial failure, of 20 South African companies were reviewed to determine if the audit reports were qualified for going concern uncertainties. The survey was confined to industrial companies that were delisted on the Johannesburg Stock Exchange (JSE) between January 1981 and May 1991, comprising a five year period before and a five year period after the issuance of AU 294 (SAICA 1986) in September 1986.

A list of 25 industrial companies whose listings were terminated on the JSE between 1981 and 1991 was supplied by the Johannesburg Stock Exchange. They are listed in tabular form in this appendix to determine if the audit report was qualified for uncertainty about the going concern assumption (see table A-1). The sample included in the survey was narrowed down to 20 companies as four companies were delisted for reasons other than financial failure and one company's financial statements could not be located.

Explanation of terms used in table A-1:

- * The *date terminated* column refers to the date the company's listing was terminated on the JSE.
- * The *date of last available audited AFS* column refers to the last audited annual financial statements that could be located for the specific company before liquidation.
- * An indication of *NQ* in the *audit opinion* column means the auditor did not qualify his opinion for going concern problems.
- * An indication of *Q* in the *audit opinion* column means the auditor qualified his opinion because of going concern problems.
- * The *period before failure* column indicates whether the auditor's opinion issued was rendered within a period of 12 months before failure or within a period of 24 months before failure. Failure in this survey is regarded as the date of the provisional liquidation, which is normally between two and three months before the date of the final liquidation. If the dates of the provisional or final liquidations were not available, the date of the termination of the company on the JSE was taken as the date of failure.

The South African auditing standard, AU 294 *Going concern* (SAICA 1986:04), places a responsibility on the auditor to evaluate information relating to a minimum of six months following the date of the audit report or one year after the balance sheet date, whichever is the later. This period represents the foreseeable future. However, AU 294 states that the auditor should also take account of events, which will or are likely to occur later than the foreseeable future period. Table A-2 lists the companies included in the sample, whose audit reports were issued in the post-AU 294 period, to determine if they have failed within the foreseeable future period that the auditor needs to consider.

Explanation of terms used in table A-2:

- * The *balance sheet date* column refers to the date of the last audited financial statements that could be located for the specific company before liquidation.
- * The *audit report date* column refers to the date on which the auditor signed the audit report included in the last audited financial statements.
- * The *foreseeable future* column refers to the defined period as stated in AU 294 (SAICA 1986), which is the later of one year after the balance sheet date or six months following the date of the audit report. The later of the two dates is marked with an (*).
- * The *failed within FF* column compares the later date of the foreseeable future column and the date of the provisional liquidation of the company (see table A-1, *included/not included* column). The provisional liquidation date is taken as the failure date. If only the final liquidation date was available, the provisional liquidation date was taken as two months before the final liquidation date. An indication of *No* in this column means that the company did not fail within the defined foreseeable future period. An indication of *Yes* in this column means that the company did fail within the defined foreseeable future period.
- * The *period beyond FF* column refers to the number of months and days beyond the foreseeable future period until the failure date, which is the provisional liquidation date.

TABLE A-1

TERMINATION OF LISTINGS OF INDUSTRIAL COMPANIES ON THE JSE OWING
TO FINANCIAL FAILURE FROM JANUARY 1981 TO MAY 1991

Company	Date terminated	Included/ not included	Date of last available audited AFS	Audit opinion	Period before failure
Amalgamated Medical Services	06/08/85	Not included. Delisted due to a scheme of arrangement.	-	-	-
Arontex Hldgs Ltd	29/01/91	Included. Provisional liquidation 20/03/90. Final liquidation 9/05/90.	28/02/89	NQ	24 months
Brohold Ltd	07/10/85	Included. In liquidation.	29/02/84	NQ	24 months
Bromain Hldgs Ltd	07/10/85	Included. In liquidation.	29/02/84	NQ	24 months
Central Data Systems	28/11/89	Included. Provisional liquidation 26/10/89. Final liquidation 23/01/90.	31/07/88	NQ	24 months
Channel Mining Inv	16/04/91	Included. In liquidation.	30/06/89	NQ	24 months

Frasers Consolidated Ltd	29/06/90	Not included. Delisted owing to restructuring.	-	-	-
GBS Hldgs Ltd	19/09/89	Included. Final liquidation 15/08/89.	30/06/88	NQ	12 months
Greenfield Prop Hldgs	19/02/91	Included. Provisional liquidation 4/12/90. Final liquidation 12/02/91.	30/06/89	NQ	24 months
Hanhill Ind Ltd	13/02/85	Included. Provisional liquidation 13/08/85. Final liquidation 1/10/85.	31/12/83	Q	24 months
Hepworths Ltd	28/10/85	Included. In liquidation.	28/02/85	Q	12 months
Hugh Parker	09/12/83	Not included. Delisted owing to restructuring.	-	-	-
National Acceptances Ltd	31/07/85	Included. Provisional liquidation 16/08/85.	31/12/84	Q	12 months
Quality Tyres Ltd	27/02/90	Included. Provisional liquidation 8/12/89. Final liquidation 9/01/90.	29/02/88	NQ	24 months

S A Selected Hldgs	09/12/83	Included. Provisional liquidation 29/11/83.	28/02/82	Q	24 months
Scope Ind Hldgs Ltd	12/03/86	Included. Provisional liquidation 13/02/86. Final liquidation 15/04/86.	30/06/85	NQ	12 months
Spectrum Ind Ltd	15/01/91	Included. Provisional liquidation 27/06/90.	31/12/88	NQ	24 months
Supertrans Hldgs Ltd	19/02/91	Included. Provisional liquidation 4/12/90. Final liquidation 22/01/91.	30/06/88	NQ	24 months
TDH Hldgs	11/12/85	Included. In liquidation.	31/12/84	NQ	12 months
Thruput Ltd	06/02/90	Included. Final liquidation 12/12/89.	28/02/89	NQ ¹	12 months
Triten	19/01/84	Not included. Provisional liquidation 14/06/82. Final liquidation 7/09/82.	No annual financial statements could be located.	-	-

¹ The auditor's report was qualified for the effect of any adjustments in the event of the company having carried out a physical stock take. No mention of going concern problems.

Turf Hldgs Ltd	14/06/88	Included. Provisional liquidation 26/02/88. Final liquidation 17/05/88.	30/06/86	Q	24 months
Willsgrove Brick & Potteries Ltd	29/03/85	Not included. Obtained listing on Zimbabwe Stock Exchange.	-	-	-
World of Leisure Hldgs	29/05/90	Included. Provisional liquidation 21/11/89. Final liquidation 20/03/90.	29/02/88	NQ	24 months
World of Music Hldgs	16/04/91	Included. Final liquidation 7/02/91.	28/02/89	NQ	24 months
Q - Qualification because of going concern problems NQ - No mention of going concern problems					

TABLE A-2

DETERMINATION OF THE FORESEEABLE FUTURE PERIOD FOR
THE COMPANIES FAILING IN THE POST-AU 294 PERIOD

Company	Balance sheet date	Audit report date	Foreseeable future		Failed within F/F	Period beyond F/F
			One year after B/S date	Six months following A/R date		
Arontex Hldgs Ltd	28/02/89	30/06/89	28/02/90 *	31/12/89	No	20 days
Central Data Systems	31/07/88	20/10/88	31/07/89 *	20/04/89	No	2 mos 26 days
Channel Mining Inv	30/06/89	24/11/89	30/06/90 *	24/05/90	No ²	9 mos 16 days
GBS Hldgs Ltd	30/06/88	23/09/88	30/06/89 *	23/03/89	Yes	-
Greenfield Prop Hldgs	30/06/89	27/09/89	30/06/90 *	27/03/90	No	5 mos 4 days
Quality Tyres Ltd	29/02/88	26/04/88	28/02/89 *	26/10/88	No	9 mos 8 days

² The final or provisional liquidation dates were not available. The date of the termination of the company's listing was taken as the date of failure.

Spectrum Ind Ltd	31/12/88	12/06/89	31/12/89 *	12/12/89	No	5 mos 27 days
Supertrans Hldgs Ltd	30/06/88	06/09/88	30/06/89 *	06/03/89	No	17 mos 4 days
Thruput Ltd	28/02/89	09/06/89	28/02/90 *	09/12/89	Yes	-
World of Leisure Hldgs	29/02/88	30/05/88	28/02/89 *	30/11/88	No	8 mos 21 days
World of Music Hldgs	28/02/89	06/10/89	28/02/90	06/04/90 *	No	8 mos 7 days



APPENDIX B

A SUMMARY OF THE MAIN FINDINGS BETWEEN THE DIFFERENCES IN KNOWLEDGE STRUCTURING AND DECISION MAKING OF EXPERT VERSUS NOVICE AUDITORS

As discussed in section 5.3.1 of chapter 5, Choo (1989:115-117) reviewed research studies that examined the differences in knowledge structures used by expert and novice auditors in making professional judgments and the differences in judgment competence between these auditors.

The findings of this review are subdivided into:

- * information-acquisition behaviour (see table B-1)
- * information-integration behaviour (see table B-2)
- * decision performance (see table B-3)

TABLE B-1

INFORMATION-ACQUISITION BEHAVIOUR

Expert auditor	Novice auditor
<ul style="list-style-type: none"> * Relies on hypotheses, rules of thumb, structured checklists, or standard lists of questions to guide information search. * Builds an overall picture, or develops a "feeling" for the task based on prior knowledge. * Searches for contradictory evidence and consistently focuses on potential contradictions. 	<ul style="list-style-type: none"> * Relies on a simple, passive, undirected, sequential information search. * Lacking among novices. * Ignores contradictory evidence.

TABLE B-2

INFORMATION-INTEGRATION BEHAVIOUR

Expert auditor	Novice auditor
<ul style="list-style-type: none"> * Integrates both supporting and contradicting evidence to zero in on underlying problems. * Organises the wide-ranging incoming information into large chunks of information. * Responds to the deeper features of information as a result of well-developed schemas. * Recalls more information (cues). * Clusters the wide-ranging incoming information into proper categories. * Verbalises more (number of words) in processing information. * Engages in less information-processing time. * Exhibits mixed evidence of interactive cue processing. 	<ul style="list-style-type: none"> * Integrates supporting evidence only and ignores contradictory evidence. * Unable to handle the wide-ranging incoming information, thus forced to organise into smaller chunks. * Responds to the surface features of information as a result of less well-developed schemas. * Recalls less information (cues). * Lacking among novices. * Verbalises less in processing information. * Engages in more information-processing time. * Exhibits mixed evidence of interactive cue processing.

TABLE B-3
DECISION PERFORMANCE

Expert auditor	Novice auditor
<ul style="list-style-type: none"> * Shows different frequency distributions (shapes) of decisions from novices. * Shows higher level of confidence in predictions/decisions. * Decisions are not affected by verbalisation (protocol analysis). * Judgments are more likely to suffer from "conjunctive fallacy".¹ * Judgments differ significantly from novices in unstructured and semistructured tasks. * Mean predictions are <i>not</i> significantly different from novices. * Shows mixed evidence on judgment consensus. 	<ul style="list-style-type: none"> * Shows different frequency distributions (shapes) of decisions from experts. * Shows lower level of confidence in predictions/decisions. * Decline in decision performance in verbalisation. * Judgments are less likely to suffer from "conjunctive fallacy". * Judgments are the same as those of the experts in structured tasks. * Mean predictions are <i>not</i> significantly different from those of the experts. * Shows mixed evidence on judgment consensus.

¹ Adding a common feature to a pair of stimuli produces an increase in the judged similarity between the pair, whereas adding a distinctive feature to either member of the pair decreases judged similarity. The resultant judgment is said to have suffered from a "conjunctive fallacy". (Choo 1989:113.)



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